PN-ABQ 442

SELECTED READINGS ON INSTITUTIONAL REFORM AND THE INFORMAL SECTOR

Workshop on Institutional Reform
Puerto Azul, The Philippines
March 7-8, 1990

Bureau for Private Enterprise
U.S. Agency for International Development

Sponsored by: *Private Enterprise Development Support Project II*
Project Number 940-2028.03
Contract Number PDC-2028-Z-00-7186-00
Prime Contractor: Coopers & Lybrand

Note

Ernst & Young was the prime contractor for the Private Enterprise Development Support Project II (Project Number 940--2028.03) until October 1, 1991. On October 1, 1991, this project was transferred to Coopers & Lybrand, which is now the prime contractor. Because this report was produced prior to October 1, 1991, it may contain references to Ernst & Young.

2

TABLE OF CONTENTS

Part I - Preliminary Readings

Section 1 - IRIS Project Identification Document

Section 2 - Informal Sector Literature Review

Section 3 - Institute for Liberty and Democracy (ILD): Action Programs

Part II - Resource Materials

Section 1 - ILD Training Programs: Module 1

Section 2 - ILD Training Programs: Module 2

Section 3 - ILD Training Programs: Module 3

Section 4 - ILD Training Programs: Module 4

Section 5 - National Debureaucratization Program of Brazil

Section 6 - Popular Mortgage: A First Step Toward Legal Security and Democratizing Credit

Section 7 - Building Constituencies for Economic Change

Section 8 - Excerpts from the "Journal of World Development"

Section 9 - The Informal Sector: Issues in Policy and Programs

PART I
PRELIMINARY READINGS

- SECTION 1 -

IRIS PROJECT IDENTIFICATION DOCUMENT

Institutional Reform and the Informal Sector

The Bureau for Private Enterprise is developing a project entitled Institutional Reform and the Informal Sector (IRIS) which will begin in the summer of FY 90. The IRIS project is the outgrowth of the work of Hernando de Soto and the Institute for Liberty and Democracy (ILD) in Peru. The ILD has done important work in the promotion of Peruvian property rights, administrative simplification, access to insurance and credit, and encouraging public participation in the rulemaking process.

The IRIS project is designed to promote better laws and institutions which will facilitate broad-based private sector-led economic growth. The project seeks to support developing country institutes around the world in identifying the legal and administrative impediments to market growth and in developing strategies for correcting these deficiencies. The aim of IRIS is to create an environment to allow the market system to work for everyone, particularly those who have traditionally been excluded from economic growth because they lacked the benefits of the formal economy.

The project addressses several related issues that are central to the effectiveness of economic development initiatives worldwide. One is the problem of identifying the institutional impediments that keep markets from operating efficiently and limit investment and growth. Another is the nature and role of the informal sector and its significance as a symptom of inadequate institutions. A third is the problem of how to enact reforms that will be sustainable and enable markets to operate more efficiently.

IRIS will support four main activities:

-- Collaborative Research and Technical Assistance: The objective is to assist developing country institutes in identifying legal and administrative bottlenecks which discourage private sector growth and full participation in the formal economy and in the democratic process. Leading U.S. economists, business and legal scholars will be linked with individuals who want to effect institutional changes in developing countries.

-- Short-term training: The project will support short-term, in-country or third-country training on key topics dealing with institutional reform and the informal sector.

-- Networking: Networking activities will be supported among U.S. and LDC researchers, practitioners and policymakers. We will be initiating a scholarly journal to which developing country researchers and reformers will submit articles on their experiences in institutional reform and the informal sector. We will also disseminate relevant information and sponsor occasional conferences.

-- Institution strengthening: This will provide resources to developing country institutes to develop/enhance their capacity to administer effective research and advocacy programs.

PROJECT IDENTIFICATION DOCUMENT

INSTITUTIONAL REFORM AND THE INFORMAL SECTOR (IRIS) PROJECT (940-0015)

PROJECT IDENTIFICATION DOCUMENT
INSTITUTIONAL REFORM AND
E INFORMAL SECTOR (IRIS) PROJECT
(940-0015)

Table of Contents

		Page
EXECUTIVE SUMMARY		i
I.	PROGRAM FACTORS	
A.	Conformity with PRE Bureau's Private Sector Initiative	1
B.	Relationship to A.I.D. Development Strategy	2
II.	PROJECT DESCRIPTION	
A.	Problems Addressed by the Project	4
B.	Project Goal and Purposes	7
C.	Expected Achievements	8
D.	Outline of the Project and How It Will Work	9
III.	FACTORS AFFECTING PROJECT SELECTION AND FURTHER DEVELOPMENT	
A.	Social Considerations	13
B.	Economic Considerations	14
C.	Relevant Experience with Similar Projects	16
D.	Grantee	19
E.	A.I.D. Support Requirements	20
F.	Estimated Costs and Methods of Funding	20
G.	Design Strategy	20
H.	Recommended Environmental Threshold Decision	21
I.	A.I.D. Policy Issues	21
J.	Gray Amendment	21

EXECUTIVE SUMMARY

The Institutional Reform and the Informal Sector (IRIS) Project is designed to promote sustainable economic growth in 5 to 6 developing countries in two ways: (1) by identifying the legal and administrative impediments that limit growth and expansion of private enterprises in the formal economy, and (2) by assisting individuals in developing countries in the design and implementation of institutional reforms that will enable markets to operate more efficiently.

The Project addresses three related issues that are central to the effectiveness of economic development initiatives worldwide. One is the problem of identifying the institutional impediments that keep markets from operating efficiently and limit investment and growth. The second is the nature and role of the informal sector and its significance as a symptom of inadequate institutions. (The informal sector is loosely defined as entrepreneurs who, although operating outside the law, are providing legal goods and services.) The third is the problem of how to institutionalize reforms that will enable markets to operate more efficiently. Responses to the first and third problems require analysis of the second issue.

Recognition of the importance of these issues has grown considerably since the publication of Hernando de Soto's book, The Other Path, on the informal sector in Peru. This book has focused attention on the need to examine further the relevance of de Soto's arguments in other countries. It is in this context that the Bureau for Private Enterprise (PRE) has designed the IRIS Project. The project stresses problem identification and problem solving in a limited number of countries and, as such, is designed to have an impact on laws and regulations governing such areas as property rights, contract enforcement, and government licensing of business.

The principal purpose of the IRIS Project is to promote better laws and institutions that can facilitate broad-based, market-led economic growth in 5-6 target countries. To accomplish this purpose, the project will support three main activities:

- Collaborative Research and Technical Assistance

  The first and principal activity is devoted to collaborative research and technical assistance in 5-6 countries. Its objectives are: (1) to identify legal and administrative bottlenecks which discourage private investment and contribute to the growth of informality, and (2) to solve specific problems through direct operational assistance to field missions and host country representatives.

- Short-term Training

  The project will support short-term, in-country or third-country training on key topics dealing with institutional reform and the informal sector.

- Networking

  The third project component will be to support networking activities between US and LDC researchers, practitioners, and policymakers. This will include establishing linkages between US and host country individuals to conduct collaborative research, collecting and disseminating relevant information, and sponsoring conferences and occasional publications.

INSTITUTIONAL REFORM AND THE INFORMAL SECTOR (IRIS) PROJECT

I. PROGRAM FACTORS

A. Conformity with PRE Bureau's Private Sector Initiative

The principal objective of the Bureau for Private Enterprise (PRE) is "to provide support for the establishment and growth of indigenous private enterprises in LDCs as a cost effective means of achieving broad-based, self-sustaining economic growth and development." The Institutional Reform and the Informal Sector (IRIS) Project is linked to this private sector initiative in two important ways: (1) it supports identification of barriers to the creation and growth of private sector enterprises, and (2) it promotes development of strategies for broad-based, self-sustaining economic growth and development.

1. Identification of Impediments to Private Sector-Led Growth

Support for private sector initiatives requires a comprehensive approach to strengthening a country's legal and administrative institutions to assure that they provide incentives rather than disincentives to investment and growth. It is becoming widely acknowledged that a country's institutional framework can hinder the entrepreneurial energies of the poor and curb the growth and expansion of private sector firms in the formal sector. Consequently, if A.I.D. is to support the creation and expansion of indigenous private enterprises it must assess the way in which laws as well as administrative rules and regulations affect private sector investment.

The IRIS Project supports A.I.D.'s private sector initiative by focusing attention and casting new light on the legal and administrative institutions that obstruct participation in the formal economy of 5-6 countries, and by developing strategies to implement institutional reforms in these countries. In developing a better understanding of the legal and administrative impediments to growth and of likely strategies for change, the Project will contribute to the establishment of growth-oriented policies that encourage competitive market forces and help channel the entrepreneurial energies of the poor in the targetted countries.

2. Development of Strategies for Promoting Broad-Based, Sustainable Economic Growth

Despite the emphasis placed by A.I.D. and other international donors on policy reforms that will spur market-led growth, implementation of these reforms has proceeded at a slow pace and

has not always achieved the results expected. The success of policy reform initiatives by A.I.D. as well as other international development agencies has been limited to an important degree by institutional constraints in the host countries, which donor institutions have not always taken into account.

Often, the policies and programs of international development agencies have placed primary emphasis on traditional macroeconomic approaches that emphasize "getting the prices right" by implementing reforms from the top-down, and have failed to pay sufficient attention to the institutional bottlenecks to economic growth and to the political sustainability of economic reform programs. The agenda of the IRIS Project attempts to correct this imbalance by focusing on how the rules of the game (as set by the institutions) affect investment and production (economic growth) and on how these rules can be effectively changed. The final products of the agenda will include a knowledge base on the institutional requirements for enabling markets to operate more efficiently in 5-6 target countries, and a set of strategies in institution building for economic growth.

B. Relationship to A.I.D. Development Strategy

In the decades since World War II, A.I.D. has put forward many policies and programs in an attempt to promote economic growth in LDCs. Economic growth has been and continues to be the central strategy of US development assistance. It is only through sustained economic growth that developing countries can increase the standards of living of the majority of their populations. In reviewing the effectiveness of its programs in promoting sustainable economic growth, A.I.D. has concluded that:

- Policies that encourage competitive market forces are key to attaining sustainable economic growth in LDCs;
- Institutions play a crucial role in creating and maintaining growth-oriented policies;
- Policies and programs of international development agencies often place too much emphasis on changing macroeconomic policies and fail to pay sufficient attention to institutional bottlenecks and political constraints to implementing those changes.

The IRIS Project will assist A.I.D. in charting new and more effective paths for promoting economic growth and equity in developing countries by identifying and analyzing the legal and administrative bottlenecks that constrain growth in 5-6 developing countries and by identifying the requirements that

12

will enable markets to operate more efficiently in those countries.

Development policy and assistance programs must be devised based on proposals for economic reform that recognize both the limits imposed by institutions and the realistic opportunities that a modification of these institutions will offer policymakers striving to change the course of economic development in a particular country. The IRIS Project aims at accomplishing just that by examining the legal and administrative constraints to economic growth in 5-6 developing countries, and the ways in which aid can best be applied to the development of policies and institutions that will foster prosperity among broader segments of the population of these countries.

The IRIS Project builds on and complements activities by a number of other bureaus. These activities are summarized in Section III-C.

II. PROJECT DESCRIPTION

A. Problems Addressed by the Project

The IRIS Project addresses three questions that are central to the effectiveness and success of economic development initiatives and that remain largely unexplored:

(1) What are the institutional bottlenecks that constrain private sector-led, sustainable economic growth in developing countries?

(2) What is the nature of the informal sector and what is its role in promoting economic growth with equity?

(3) How does one get governments to commit to reform and how can these reforms be institutionalized?

1. Institutional Impediments to Growth

To understand the process of economic development, it is necessary to appreciate the nature and role of institutions (legal, political and administrative) in shaping the environment and the possibilities for sustained economic growth in Third World countries. Institutions constitute the rules of the game that govern economic exchange: they can encourage or discourage investment and production, and facilitate or impede the effective functioning of markets.

Institutions play a key role in economic development through their effects on the costs of transactions which, in turn, influence the behavior of economic agents with respect to the allocation and utilization of economic resources. When laws and institutions provide for the effective protection and enforcement of property rights and other contractual arrangements, transaction costs are lowered, and markets are more efficient. If, on the other hand, the legal framework is inadequate, transaction costs are high and block the efficient development and operation of the market.

Efforts by A.I.D. to promote market growth have been hindered by institutional barriers, including lack of protection and enforcement of property rights; high costs for establishing or expanding a business; preferential access to credit; inadequate contract enforcement mechanisms; and inconsistent application of laws. The IRIS Project will address these types of problems by supporting identification of the key institutional (legal and administrative) barriers which are limiting entrepreneurial development and economic growth in different regions and countries of the world.

14

2. Nature and Role of the Informal Sector

Growth of the informal sector in LDCs is not a new phenomenon. International donor agencies and development professionals have, for many years, looked upon the informal sector as a potential source of employment and income for the poor, and have developed projects to assist the informal sector in gaining access to capital, training, and technical assistance.

More recently, however, attention has shifted to focus on the causes and characteristics of informality in the context of developing economies. This shift has come about largely as a result of the work of Hernando de Soto and the Instituto Libertad y Democracia (ILD) in Peru. De Soto has challenged traditional views of the informal sector as employer of last resort for the poor, and has focused instead on the entrepreneurial qualities of informality and on the institutional impediments to participation in the formal economy. (The informal sector is loosely defined as entrepreneurs who, although operating outside the law, are providing legitimate goods and services.)

De Soto views the choice between working formally or informally as a rational process ensuing from analysis of the relative costs and benefits of formal sector participation in the context of a highly complex and inadequate legal and regulatory environment. He argues that the low levels of growth of the economy arise from the "high costs of formality", which result in: low productivity due to inefficient specialization; low levels of productive investment; high taxes which discourage creation and expansion of business; and disincentives to technological progress and innovation. In short, the roots of underdevelopment can be traced in large measure to government policies and institutional impediments which raise the costs of transactions required for participation in the formal economy, and encourage exit into the informal sector.

Although evidence on the magnitude of informal sector activities in most developing countries is still scanty at best, preliminary studies suggest that some 40-50 percent of the GDP of developing countries may come from contributions made by the informal economy, and that this sector is playing and will continue to play a central role in the economic development of these nations. Moreover, the impressive magnitude of informal sector activities makes evident the enormity of the institutional dysfunction which is forcing so many economic participants into less than optimal investment and production conditions. The magnitude of the informal sector, however, insofar as it embodies the entrepreneurial energies of the poor, also points to the latent growth opportunities that might be exploited if the key impediments can be removed.

The IRIS Project can play an important role in promoting analysis of the role laws and institutions play in encouraging/discouraging participation in the formal economy, and in discouraging/encouraging entrance into the informal economy. For A.I.D. and other international development agencies, study of the institutional framework in individual countries is fundamental to understanding the causes of informality and underdevelopment in Third World countries.

The IRIS Project will assess the legal and administrative impediments to private sector growth reflected by informality as well as identify strategies for channeling the energies of the sector toward positive ends. It will focus resources selectively in a number of countries to explore who the informal sector is, what institutional deficiences explain its existence and growth, and how these flaws can be corrected so as to allow broad-based private enterprise to flourish.

3. The Politics of Sustaining Pro-Growth Policies

In recent years, a growing number of developing countries have expressed their commitment to private sector initiatives and have recognized the importance of increasing the role of the private sector in the economy in an effort to reverse negative trends in economic growth. Yet, it is unrealistic to expect that it is only necessary to point out the impediments to growth created by these policies to bring about the necessary policy and institutional reforms. Moreover, economic policies, laws and regulations are often designed in response to pressures from powerful interest groups ("mercantilists" as de Soto calls them), or as a result of ethnic or strategic considerations. Consequently, many LDC governments are limited by political and other considerations in what they can change and in how rapidly they can institute the reforms required for promoting and sustaining pro-growth policies.

Unfortunately, the policies and programs of international donor agencies often have failed to pay adequate attention to the political and institutional constraints to reform. Critics of these programs argue that they are sometimes too abstract, and that they ignore crucial political and institutional aspects of implementing and sustaining policy reforms. The bottom-up or local ownership approach to implementing policy reforms has often been absent. For example, the structural adjustment programs of the International Monetary Fund and the World Bank often focus on "getting the prices right" in the short-term by adjusting exchange rates and eliminating price controls, while paying insufficient attention to institutional bottlenecks like ineffective legal systems or political coalition-building.

By focusing attention on the institutional constraints to economic growth in different Asian, African, and Latin American

16

countries, the IRIS Project will shed light on the political economy of reform, and assist in developing programmatic interventions in support of policy and institutional reforms that are implementable in particular developing countries. For example, research under the project will explore questions such as (a) what factors determine the political sustainability of policy reform programs in a particular country and how can these be influenced? and (b) what are the instruments or strategies for implementing bottom-up versus top-down approaches?

B. Project Goal and Purposes

The goals of the IRIS Project are to assist US and LDC policymakers in (1) identifying key institutional (legal and administrative) impediments to private sector-led development, and (2) correcting these deficiencies through bottom-up institutional reforms that promote more effective functioning of markets and broad-based, sustainable economic growth.

The main purpose of the project is to promote better laws and institutions that can facilitate broad-based, private sector-led economic growth. As a corollary to this, the project also has the following three purposes:

1. To Develop a Knowledge Base on the Relation Between Institutions and Economic Growth

A key purpose of the IRIS Project is to develop a knowledge base on the relation between institutions and economic growth in 5-6 developing countries that will further a better, more comprehensive understanding of the institutional requirements for attaining adequate and sustainable rates of economic growth through broader private sector participation in the economy.

2. To Develop a Pool of Expertise in the US and LDCs

A second purpose of the IRIS Project is to develop a pool of experts both in the United States and in the Third World who are knowledgeable about the impact of institutions on economic growth and who can both influence thinking on institutional reform and the informal sector, and assist in actual design and implementation of reforms. In addition, U.S. experts will be accessed to provide state-of-the-art technical assistance to A.I.D. missions and host country policymakers and practitioners in institutional analysis and in strategy design and implementation. Assistance will focus on: (a) problem identification through research on and analysis of legal and administrative impediments to economic growth in particular countries, and (b) problem solving through mapping of realistic reform strategies.

3. To Promote Bottom-Up Development Strategies

A third purpose of the project is to promote development of effective strategies for implementing reforms that are supported and advanced by broad constituencies in developing countries (bottom-up), as alternatives to top-down approaches with short-run, get-the-prices-right objectives. The project will explore the requirements for implementing bottom-up approaches that recognize the importance of the institutional context, and the political and social dimensions of reform.

C. Expected Achievements

The principal achievement of the IRIS Project will be improved laws and institutions in a selected number of countries. By supporting identification of key institutional impediments to private sector participation in the economy, as well as development and implementation of reform strategies, the project is designed to have an immediate impact on the institutional infrastructure of target countries. This impact will be made in such areas as property rights, contract enforcement, patents/copyrights, insurance, government licensing of business, and access to government services. This achievement will rest on the following expected accomplishments of the project:

1. In-Depth Understanding of Legal and Administrative Constraints to Growth in Selected Countries

By supporting applied research in a selected number of countries on a number of legal and administrative constraints to investment by private sector enterprises, the IRIS Project will lead to a better understanding of the institutional constraints to, and the requirements for, sustained economic growth and development in specific countries. This knowledge base on the relation between institutions and economic growth can be used to support comparative analyses and further research in other countries. Moreover, the knowledge base created under the project will serve as the foundation for the development of other programs and interventions by international development agencies.

2. Expanded Cadre of Researchers and Practitioners in the US and in the Third World

By supporting collaborative research, in-country training, and networking between US and LDC researchers and practitioners, the IRIS Project will mobilize additional US and LDC academic and technical talent and, thus, create an expanded cadre of experts in institutional analysis and strategy development. The objective of creating an expanded cadre of "neoinstitutionalists"

is twofold: on the one hand, the project will increase the pool of experts who can provide state-of-the-art technical assistance in an emerging field and who can be "tapped" by A.I.D. and other international development agencies; on the other hand, the objective is to promote local ownership of ideas by supporting a larger pool of individuals who can engage in research to identify specific impediments to formal participation in the economy, and recommend specific reforms in their own countries.

3. Effective Strategies for Implementing Reform from the Bottom-Up

The IRIS Project is expected to contribute to the development of more effective strategies for implementing reforms from the bottom-up. This will be accomplished in two primary ways: (a) through collaborative research and technical assistance to identify appropriate instruments or strategies for implementing reforms in particular countries, and (b) through operational support in the implementation of particular reforms. For example, the results of applied research in a particular country might indicate that, like in Peru, access to credit for informal sector entrepreneurs is limited by lack of property rights (i.e. lack of title to land or housing which could be used as collateral). In addition to identifying the problem (i.e. the particular pieces of legislation or paperwork which inhibit land titling), the project will also support evaluation of the best course for solving that problem (i.e. how to enable informals to register their land and how to mobilize support for such reform), and provide access to experts who can assist in implementing that reform (i.e. drafting a new land titling system and a credit mortgage system applicable to the particular country context).

Moreover, in order to promote a bottom-up approach, the IRIS Project will stress reliance on home country individuals with the knowledge and ability to carry out research and advocacy on issues related to institutional reform and the informal sector.

D. Outline of the Project and How it Will Work

The IRIS Project will have three essential components:

1. Problem Identification and Problem Solving in a Country-Specific Context

The first and principal component of the IRIS Project will be devoted to: (a) identifying specific legal and administrative problems through collaborative research and technical assistance in 5-6 countries, and (b) solving specific problems through direct operational/technical assistance to field missions and host country representatives.

19

The main objective of this activity is to identify the institutional requirements for enabling markets to operate more efficiently in selected developing countries. To achieve this goal, the IRIS Project will address the following problems in 5-6 countries in Asia, Africa and Latin America:

- Growth of Informality/Limits to Formality
- Limited Private Sector Participation in the Economy
- Inadequate Protection and Enforcement of Property Rights
- High Transaction Costs/Low Levels of Investment
- Inadequate Contract Enforcement Mechanisms

In analyzing the problems identified above, the IRIS Project will explore the following types of questions. Moreover, central to each of the questions identified below is the issue of strategy formulation and implementation, that is, how to get governments to commit to reform and how to institutionalize those reforms.

Question #1: What explains differences in the degree and composition of the informal sector (illegal enterprises pursuing legal means) among different countries? For example, (a) why is the informal sector some 50% of the economy of Peru and significantly less in other countries like Thailand? (b) what discrete groups make up the informal sector in different countries and why? and (c) which sectors of the economy are more informal in different countries and why?

Question #2: What allows certain private enterprises to flourish in LDCs? What accounts for the "excellence" of these successful enterprises? What types of informal enterprises have grown successfully into formal enterprises and what strategies did they pursue? Was gender or ethnicity a factor? What role did linkages between informal and formal enterprises play in this "graduation" from informality?

Question #3: How are property rights affecting economic growth in a particular country? For example, (a) what is the value/cost of informal property rights in securing access to finance for new investment in a particular sector or country? (b) do certain discrete groups have more access to property rights than others? (c) how are current patent and

20

copyright laws affecting technological progress and (d) how can these laws be improved?

Question #4: What is the level of transaction costs (e.g. government regulations) in a particular economic sector and what impact are they having on new investment and on expansion of current investment? What laws and regulations need to be revised to lower transaction costs and how can this be done?

Question #5: How are prevailing contract enforcement mechanisms affecting commercial relations, investment and economic growth in a particular country and how can these mechanisms be improved? Are these mechanisms applied differentially across discrete groups?

2. Short-Term Training

The IRIS Project will support short-term, in-country or third-country training for a cross section of policymakers and private sector researchers, practitioners and entrepreneurs from the formal and the informal sectors. Training will serve to foster discussion on the relationship between institutions and economic growth, build the capability of host country researchers and practitioners to carry out additional research, and develop strategies for reform. Examples of possible short-term training topics might include:

- Transaction costs (laws, policies, regulations, information) and their impact on business growth
- Creating a facilitative environment for private enterprise
- Achieving excellence in private sector enterprises
- Expanding the role of the poor as entrepreneurs through increased participation in the formal economy
- Building support for institutional reform (public education/advocacy)

3. Networking in the US and LDCs

The project will promote development of informal networks between US and LDC researchers, practitioners and policymakers. This will be accomplished in the following way: The institution selected to administer the project will function as a brokerage firm dealing in the development of linkages between US and Third World research centers, and in promotion of collaborative

research efforts. It will serve as a center for information on questions relating to institutional reform and the informal sector. In addition, the institution will be responsible for:

- collecting information on the state-of-the-art of institutional analysis and reform;
- disseminating information on on-going research and field activities worldwide;
- holding conferences and seminars;
- sponsoring occasional publications.

22

III. FACTORS AFFECTING PROJECT SELECTION AND FURTHER DEVELOPMENT

A. Social Considerations

1. Socio-Cultural Context

Increasingly, the informal sector has come to be viewed as a symptom of institutional (legal, political, and administrative) barriers which distort the operations of the market and raise the costs of entry and financing of new firms. The result of these impediments and of the widespread informality is, in effect, limited economic growth due to low levels of investment, low productivity arising from inefficient specialization, and disincentives to technological innovation. At the same time, research on the informal sector has underlined the resourcefulness and enterprise of informal sector activities, and the potential impact of these activities on economic growth. While still scanty, available information indicates that in some countries informal sector activities may contribute from 40 to 50% of GDP. The economic implications of making these activities more productive and efficient are indisputable.

In this context, development of the IRIS Project is particularly appropriate because it addresses two related problems. One is the problem of institutional impediments to private sector participation in the economy. The other is the problem of implementing reforms to improve the efficiency and equity of markets. Both of these areas require thorough analysis of the informal sector and of the institutions which foster informality and hinder efficient markets.

2. Impact and Beneficiaries

The level of resources applied through the IRIS project is limited relative to the need for this type of problem identification and problem solving support in developing countries. For this reason, the IRIS project will target a limited number of countries and address only a limited number of institutional problems. Nonetheless, the IRIS project will have a number of significant positive effects.

The IRIS project is designed to have an immediate impact on the institutional infrastructure that governs incentives and disincentives to private sector growth in selected target countries. This will benefit entrepreneurs in general, but will affect small and micro-entrepreneurs in particular because these groups tend to comprise a large segment of the informal sector in most countries. In addition, because women are key participants in informal sector activities, the project will benefit women in at least two important ways: (a) by focusing attention on the productive potential of women in economic development and, (b) by supporting strategies that focus on removing impediments to

private sector participation in the economy regardless of gender, and that rely on women and the poor as key political, economic and social actors.

In addition, because the IRIS project stresses local, broad-based (bottom-up) strategies for reform, it is expected to contribute to more effective donor interventions that are also more sustainable than traditional top-down approaches. Moreover, the knowledge base developed by the project on the relation between institutions and economic growth will serve as a point of departure and comparison for future programs by international donor agencies, policymakers in LDCs, and other development professionals.

B. Economic Considerations

Design of the IRIS Project was based on the following economic considerations:

1. Appropriateness of Investing Scarce Resources to Address the Perceived Problem

In recent years, a growing number of LDCs have re-focused attention on the need to improve the efficiency and equity of markets to reverse negative trends in economic growth and to broaden participation in the economy. Because the IRIS Project will offer assistance in identifying the institutional constraints to efficient market operations in LDCs as well as in developing solutions for improving the institutional framework, it represents a timely and appropriate use of scarce resources that responds to the requirements of LDC researchers and policymakers.

The IRIS Project also responds to the growing recognition among international development professionals that traditional macroeconomic approaches are inadequate because they ignore crucial political and institutional aspects of implementing and sustaining policy reforms. In the words of economist and Nobel laureate, Ronald Coase,

> "Until comparatively recently economists tended to devise their proposals for economic reform by comparing what is actually done with what would happen in an ideal state. Such a procedure is pointless. We can carry out the operations required to bring about the ideal state on a blackboard but they have not counterpart in real life. In the real world, to influence economic policy, we set up or abolish an agency, amend the law, change the personnel and so on: we work through institutions. The choice in economic policy is a choice of institutions. An what

24

matters is the effects that a modification of these institutions will actually make in the real world."

The IRIS Project aims at examining and modifying laws and regulations that inhibit the growth of broad-based private enterprise and, therefore, the potential for attaining and sustaining adequate rates of economic growth in developing countries. In light of A.I.D.'s goal to promote economic growth in LDCs by supporting private initiatives, the IRIS project is an appropriate investment of resources.

2. Merits of Proposed Approach to Address the Perceived Problem

In the 1980's, international development agencies like A.I.D., the World Bank, and the regional development banks have stressed policy reform in support of private sector initiatives in LDCs as the most viable path from underdevelopment. The success of these policy reform programs, however, has been limited by host country political and institutional constraints. Moreover, as A.I.D. noted in its report on "Development and the National Interest," economic development can really only take place if an LDC commits itself to "growth and opportunity-oriented" domestic policies. Thus, even though it is necessary to shape development assistance programs in order to encourage such policies, "each sovereign state must ultimately chart is own developmental course."

The IRIS Project recognizes both the limits of traditional approaches and the need to encourage local, broad-based strategies for reform. To address these issues, the project focuses on identifying legal and administrative bottlenecks in specific countries which discourage private investment and contribute to the growth of sizable informal sectors. In addition, the project stresses reliance on indigenous talent in identifying problems and in designing and implementing reform strategies.

The project's targetted approach also has considerable merit because it recognizes the limits of available resources in light of the amount of work that needs to be done to assess in each environment the particular institutional impediments which promote widespread informality, and to identify the instruments or strategies for implementing reforms from the bottom-up.

3. Limits of Alternative Project Designs

A number of alternative project designs were considered and eventually rejected. In particular, A.I.D. considered developing a research project devoted primarily to U.S.-based research by academics on the constraints to economic growth in developing countries. This effort was known in its infant stages as New Institutional Economics (NIE). In response to concerns voiced

both within PRE and the regional bureaus that the project was "too theoretical" and not operational enough, the NIE project was re-defined and the IRIS project, which focuses on applied research and direct operational support in a limited number of countries, was developed. The new design stresses problem identification and problem solving. This makes the project more operational and, thus, more immediately useful to field missions and host countries.

In order to gather information on the institutional constraints to economic growth and network with leaders active in this field, PRE sponsored three meetings with prominent members of the U.S. academic community. The last meeting, which was held on June 5 and 6 1989, led to a number of important conclusions which have influenced the design of the project. Key conclusions included:

- Traditional approaches to economic development are inadequate because they ignore crucial political and institutional aspects of implementing and sustaining policy reforms;

- The "New Institutional Economics" offers a potentially productive, interdisciplinary approach to economic development that could lead to a better understanding of the institutional impediments to economic growth and to a more effective policy reform agenda for A.I.D. and other international donor agencies;

- The work of Hernando de Soto on the informal sector in Peru has applicability in other countries, and his propositions need to be explored in Africa and Asia, as well as in other Latin American countries;

- The project's agenda should have both a research component and an action-oriented component. A research agenda is important but not sufficient, and a policy agenda is also important but not sufficient.

- More linkages need to be established between US academics and US an LDC policymakers, and between US and Third World researchers.

C. Relevant Experience with Similar Projects

The IRIS Project will build on and complement a number of current and proposed projects at A.I.D. Coordination with other A.I.D. bureau's, especially the Institute for Policy Reform project and the HIID project administered by the Bureau for Program and Policy Coordination (PPC), will be an important responsibility of PRE and of the grantee.

A summary of the principal relevant activities by other A.I.D. bureaus is provided below.

1. Latin America/Caribbean Bureau (LAC)

For the past four years, the Bureau for Latin America and the Caribbean, through its Private Sector Policy Planning and Institutional Development Project, has sponsored the work of Hernando de Soto and the Instituto Libertad y Democracia (ILD) in Peru. Support under this project has enabled de Soto and the ILD to undertake comprehensive studies of the legal, institutional and financial barriers to entry into the formal sector in Peru.

In an effort to extend the benefits of this research to other countries in the Latin America and Caribbean region, USAID/Peru has signed a new, five-year Cooperative Agreement with the ILD. This project includes a training component that will bring representatives from Africa and Asia to the ILD to learn about its experience in Peru and re-focus attention on the informal sector in other parts of the world.

2. Africa Bureau (AFR)

The Africa Bureau has sponsored conferences in Abidjan and Nairobi on the informal sector. The objectives of the conferences were:

- to identify policy measures which can promote African entrepreneurship, particularly among existing informal sector participants;
- to examine effective programs to support the informal sector; and
- to determine how advocacy programs may be established for pursuing needed reforms.

In addition, as a follow-on to these conferences, the Africa Bureau is developing a pilot training program for African researchers to be held at the ILD in Peru.

3. Asia/Near East Bureau (ANE)

In early April, the Asia/Near East Bureau sponsored developing country participants from Morocco, Egypt, Bangladesh, the Philippines, Sri Lanka and Thailand to travel to Peru to learn about ILD activities and methodology. On April 11, the Asian participants gave a day-and-a half debriefing to A.I.D./W officials. They reported that the Peruvian experience in identifying and addressing transaction costs does have relevance in Asia. It was agreed that more research is necessary to quantify transaction costs and their impact on economic growth.

As a result of the debriefing, the Asia Bureau is commissioning a book which will identify country-specific transaction costs, estimate their adverse impact on economic growth and recommend policy alternatives.

4. Bureau for Program and Policy Coordination/Economic Affairs (PPC/EA)

PPC/EA is in the second year of a research project with the International Center for Economic Growth (ICEG). The purpose of the project is to provide support for activities which contribute to the elimination of regulations which stifle economic growth. Hernando de Soto's book, The Other Path, was published under this project. The ANE Bureau's trip to Peru and the subsequent debriefing were also funded through a buy-in to this project.

PPC is also considering a proposal for the establishment of an Institute for Policy Reform and for the organization of an International Development Consortium. The main objective of the Institute is to foster research and provide access to expertise that will directly strengthen USAID operations focused on policy reform. The Institute will operate the International Development Consortium, which will provide an organizational framework for implementing innovative, educational, training, and communications programs. PPC has also developed a project on policy reform implemented by the Harvard Institute for International Development (HIID). The project will focus on design and implementation of policy reform programs.

5. Office of Housing and Urban Programs (PRE/H)

The Office of Housing and Urban Programs incorporates informal sector concerns into nearly every aspect of its programming. This is consonant with the relative importance of the informal sector in housing - estimates are that upwards of 95% of all housing for low-income households in developing countries is provided through informal mechanisms. In January 1988, the Office of Housing and Urban Programs sponsored a conference on the informal sector and its relation to shelter and urban development issues. The conference led to a report entitled "Support Strategies for Informal Production of Housing and Urban Services." This report outlined informal sector research and policy strategies for the housing guarantee program. This research and policy work is being conducted in the seven Regional Housing and Urban Development Offices (RHUDOs).

6. Bureau for Science and Technology (S&T)

The Bureau for Science and Technology has four on-going projects which involve research on the informal sector:

- Employment Enterprise Policy Analysis - This is the 5th year of a six year project through Harvard University, a component of which involves conducting studies on the informal sector. Several of these studies have been undertaken in conjunction with the Sequoia Institute's workshops on the informal sector.

- Aries - This is the 5th year of a five year project to conduct research and provide technical assistance on business development in LDCs. Many of the 40 Aries field assignments have dealt with informality.

- Ohio State University - Ohio State has been involved in research on financial markets in developing countries for over 15 years. The current and future focus of the project is on the informal financial sector.

- Financial Resources Management Project (FIRM) - This FY 1989 ten year project will support applied research on informal financial sector linkages to formal markets, improving institutional capacity, and policy reform.

- Gemini (microenterprise) - This is a project which will begin in FY 1990. It will provide research and technical assistance, principally in the informal sector.

D. Grantee

We are in the process of selecting a grantee to manage and implement the IRIS Project. Exploratory interviews have been held with representatives of a number of organizations including: the National Association of Schools of Public Affairs and Administration (NASPAA); Ohio State University; the International Center for Economic Growth; the National Academy of Sciences; the RAND Corporation; the Brookings Institution; Washington University in St. Louis; University of Wisconsin; and the Sequoia Institute.

The key criteria for selecting the appropriate institution are:

- Access to US and LDC academic and technical talent in a number of relevant disciplines, including economics, public affairs, political economy, law, industrial organization, and sociology/anthropology

- Understanding of A.I.D. requirements and experience with management and implementation of A.I.D. projects

- Linkages with Third World research and policy-oriented institutions

- Credibility with the international development community
- Publication and other information dissemination capabilities
- Management capability, including appropriate professional and support staff
- Objectivity and independence in project design and implementation
- Washington-based office

E. AID Support Requirements Capability

The IRIS Project will be centered within the the offices of the selected grantee and will be managed by a full time professional of this organization. Close monitoring and coordination will be maintained by the Private Sector Officer of PRE's Office of Project Development. This PRE officer will also be responsible for ensuring that project activities are being coordinated with other A.I.D. bureaus undertaking similar projects in order to avoid duplication.

F. Estimated Costs and Methods of Funding

Project funding will be through a cooperative grant agreement. Life-of-project authorization is $5 million. Substantive mission buy-ins are anticipated to complement core funding.

Estimated Five-Year Budget

Technical Assistance	$4.0 million
Training	0.6 million
Networking	0.4 million
Total	5.0 million

G. Design Strategy

The Project Paper design period will begin following PID approval and work toward a November 15, 1989 completion date for an FY 90 first quarter obligation. The detailed design will be produced by the selected grantee working in close coordination with PRE officers.

A key component of the PP is identification of the 5-6 countries where research and technical assistance will be provided. For this purpose, a two-person PRE team will travel to different

countries in September 1989 to market the IRIS Project and assess the requirements for selecting target countries. Country selection will depend on the following criteria:

- A.I.D.-assisted country
- Field mission interest and commitment
- Demonstration effect
- Different degrees of regulation, size of informal sector, and possibilities for reform
- Access to host country individuals with interest and ability to carry out research and advocacy on institutional reform

If additional funding is available, the project will also consider an Eastern European country like Poland or Hungary.

H. Recommended Environmental Threshold Decision

The principal activities of this project will not affect the natural or physical environment. Since the assistance provided under this project involves applied research, training and information sharing/networking on institutional analysis and strategy development not related to environmental policy, the project is exempt from an environmental impact analysis.

I. A.I.D. Policy Issues

The IRIS Project as currently proposed is entirely consistent with A.I.D. policies and guidelines governing assistance to private enterprise. Consideration of policy issues included a review of A.I.D.'s Policy Paper on Private Enterprise (Revised), March 1985. The project also addresses concerns raised by the 1988 report, "Development and the National Interest: U.S. Economic Assistance into the 21st Century," regarding the limits of current development programs and the need to focus more attention on the role of institutions in economic progress.

J. Gray Amendment

The IRIS Project will be implemented through a cooperative agreement. Gray amendment requirements will be taken into account.

31

LOGICAL FRAMEWORK
IRIS PROJECT

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
OUTPUTS	MAGNITUDE OF OUTPUTS		
- Expanded knowledge base on institutional constraints to growth in target countries	- 5 primary questions/problems identified and analyzed in 5-6 countries	- Project records - Publications	USAID and host country interest
- Product of training: increased number of indigenous experts	- Technical skills of researchers in 5-6 countries improved	- Training course records, i.e. course outline and list of participants	- Access to host country individuals with interest and ability to further research and advocacy activities on institutional reform
- Products of networking activities: conferences; information compiled and disseminated; increased linkages with Third World research institutions	- At least 1 conference per year	- Network support records, i.e. conference agenda, dissemination records, and publications	- US and LDC interest and demand for products of networking
INPUTS	FIVE YEAR BUDGET		
Technical Assistance Training Network Support	PRE 4.0 MN PRE 0.6 MN PRE 0.4 MN Mission buy-ins	- Project audit/evaluations - Annual workplans - Project reports/publications	- PRE funding of project will continue - USAIDs have sufficient interest and funding to support field work - Capabilities of grantee are adequate and responsive to AID requirements

ANNE

GICAL FRAMEWORK
IRIS PROJECT

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
	MEASURES OF GOAL ACHIEVEMENT		
GOAL: Promote broad-based, market-led, sustainable economic growth in 5-6 countries	- Improved economic performance in project assisted countries	- Current articles/publications - Country statistical data	- Adequate and sustained commitment by host countries to follow reform recommendations
SUBGOAL: Assist US and LDC policymakers in (a) identifying key institutional impediments to private sector-led growth and in (b) correcting these institutional deficiencies	- Increased awareness of specific legal, regulatory and administrative obstacles to private participation in the formal economy of target countries - Greater knowledge of informal sector activities in target countries - Better understanding of political requirements for reform of specific impediments in target countries	- Project reports and records - Project evaluation - Publications - Donor policy statements	- Donor and LDC interest and commitment to incorporating project recommendations into development of future programs
	CONDITIONS THAT WILL INDICATE PROJECT OBJECTIVES HAVE BEEN ACHIEVED - END-OF-PROJECT STATUS		
PURPOSE: Promote better laws and institutions in 5-6 target countries	- Reform proposals for revising key laws and regulations affecting property rights, contract enforcement, and government regulation of business	- Legislation - News media - Project records and evaluation	- Host country government is receptive to proposals
SUBPURPOSE: Develop knowledge base on relation between institutions and economic growth	- Increased awareness of impact of institutional bottlenecks on economic performance	- Donor policy statements - Publications	- Project life is sufficient to explore relevant questions
SUBPURPOSE: Develop pool of expertise in US and LDCs	- Expanded pool of individuals with expertise in institutional analysis and strategy development	- Roster of US and LDC individuals with relevant expertise	- Pool already exists but needs to be tapped by AID
SUBPURPOSE: Promote bottom-up development strategies	- Increased awareness by donors of political requirements for reform and decreased emphasis on traditional top-down approaches	- Donor policy/strategy statements	- Donors and policymakers are receptive to new approaches

- SECTION 2 -

INFORMAL SECTOR LITERATURE REVIEW

The Informal Sector: Perspectives from the Literature

Prepared for discussion at the Meeting on
The Informal Sector and Economic Institutional Reform
February 17, 1989

Bureau for Private Enterprise
U.S. Agency for International Development

Prepared for: *USAID/PRE*

Prepared by: *Flora M. Painter, Arthur Young*

Sponsored by: *Private Enterprise Development Support Project II*
Project Number 940-2028.03

February 1989

TABLE OF CONTENTS

		Page
I.	Introduction	1
II.	Overview of the Literature	3
III.	Main Themes in Informal Sector Literature	6
IV.	Developing a Research Agenda	10
V.	Conclusion: The Informal Sector as Symptom and Solution	13
Appendix A:	Annotated Bibliography on the Informal Sector and Economic Institutional Reform	16
Appendix B:	Selected Bibliography on Transaction Costs	37

THE INFORMAL SECTOR: PERSPECTIVES FROM THE LITERATURE

I. Introduction

A. Purpose and Objectives of the Paper

This paper provides an overview of the directions of informal sector research and the approaches that have been taken in the current literature. It is based on an annotated bibliography prepared by Arthur Young for the Agency for International Development (AID) and for distribution to the AID-sponsored "Working Group on Economic Institutional Reform".

This paper is intended to serve as a catalyst for discussion by the Working Group during its meeting on February 17th, and to assist this group in developing a research agenda that is well-focused and supports AID policy and program objectives.

B. The Informal Sector Debate in the Context of AID Objectives

The role and potential of the informal sector in the economic development of Third World nations has become the subject of considerable debate among development professionals. The recent work of Hernando de Soto of the Instituto Libertad y Democracia (ILD) in Peru has been central to this debate.

De Soto's work has stirred thinking on economic development by focusing attention on the causes and characteristics of informality in the context of developing economies. Through empirical research, de Soto has demonstrated that in Peru the principal impediments to economic growth are institutional in nature, and that the informal sector constitutes a sizable and potentially powerful force for change in support of policy and institutional reform. According to de Soto, the existence and growth of the informal sector in Peru is due to the persistence of mercantilist structures in the political economy, which distort the operations of the market and result in extensive and excessive regulations on behalf of privileged interest groups.

A key finding of de Soto's research has been that informal sector participants exhibit entrepreneurial and democratic tendencies. This finding directly challenges "cultural" theories of underdevelopment. Furthermore, by identifying the legal and institutional barriers which cause the growth of informality, de Soto has uncovered what he believes may be the "key" to economic development, at least in Latin America. The transaction costs that arise from such barriers, and that ILD is endeavoring to measure, have raised the price of entry and financing of new firms, in effect restricting economic growth.

The theoretical underpinnings of this new approach to economic development have important implications for the Agency for International Development (AID) and for the private enterprise initiative which is a key pillar of current AID policy. In its support of private initiatives in developing countries, AID has had to confront a vast array of policy constraints and institutional obstacles to the growth of private enterprise, including interest rate controls which inhibit the mobilization of savings and limit the availability of resources for productive investment, foreign exchange and price controls, and a gamut of legal and regulatory impediments to the formation, operation, and expansion of business. As a result, promotion of private initiative has required that the Agency assess the key policy and institutional constraints to private investment and growth, and engage in policy dialogue with Third World governments in favor of market liberalizing reforms that will enhance the ability of private enterprises to respond to the opportunities of the open market.

In this context, study of the informal sector and economic institutional reform is intimately linked to AID's private sector initiative. Such study helps identify the constraints and barriers to private enterprise development and market-led growth. The findings of the ILD support the view that entrepreneurial talent is available in developing countries if allowed to mature, and that the success of market-led economic development strategies is intimately linked to the reform of policies and institutions that obstruct entrepreneurial development. The study of the informal sector thus represents an important step towards developing a better understanding of the constraints to market-led economic growth based on development of private enterprise.

The work of Hernando de Soto and the ILD constitutes a potentially productive approach to the study of economic development and underdevelopment which needs to be examined further for the validity of assumptions underlying it, for the applicability of its findings and methodologies outside Latin America, and for its short and long term implications. The Agency is determined to support this endeavor by pursuing a three-pronged approach:

- Encouraging and re-focusing research by the U.S. academic community away from traditional development economics and towards a set of concepts that address and build on the theories and conclusions put forth by Hernando de Soto and the ILD;

- Developing new tools for use by AID in generating, adjusting, and implementing policies and programs that promote economic growth through economic institutional reform;

- Initiating a process of research and publication under the aegis of a prestigious institution receiving both AID and foundation support.

II. Overview of Literature

A. Origins of Informal Sector Research

The formal-informal sector dichotomy has been addressed in anthropological literature since at least the early 1960s. The concept was first introduced into the development studies literature in the early 1970s, following the presentation by Keith Hart of an influential paper on the informal sector and urban employment in Accra, Ghana. Since then, this dualistic approach has become the theoretical basis for much of the extensive literature on the informal sector.

The International Labour Organization (ILO), which was the first to incorporate Hart's concept into its research on urban employment, has played a crucial and influential role in the assimilation, selection, and publication of research on the informal sector. It is not surprising, therefore, that much of the literature on the informal sector over the last two decades has focused on the urban informal sector and its potential for generating employment and income.

In addition to the ILO, a number of other institutions helped shape the debate and focus of informal sector research in the earlier stages of its development. Most notable among them are the Institute of Development Studies at Sussex (U.K.), Harvard University, the Massachusetts Institute of Technology, the United Nations, and the World Bank. AID's Bureau of Science and Technology also has played and is playing a key role through its support of research on rural development and microenterprise development.

B. Principal Research Phases/Approaches

1. The "ILO Approach": The Informal Sector as Employer of Last Resort

The dichotomy between the rural (traditional) and urban (modern) economies was a central influence on early research on the informal sector. Beginning with the premise that as national economies industrialize a greater portion of the labor force must be absorbed by non-agricultural activities, much research has focused on explaining how rural migrants manage to survive at the margins of the more modern urban economies.

The explosive increase in population in the principal cities of many developing countries, resulting both from high total

population growth rates and migration from the rural areas, attracted the concern of the International Labour Organization and other international development agencies, and served to propel much research on the informal sector. The "failure" of modernization strategies to absorb increases in population forced new entrants into the labor force to create their own employment in the informal sector. Thus, a number of studies have viewed the informal sector to a significant extent as a "safety valve" or employer of last resort for the masses of jobless migrants.

In this context, the ILO launched a series of survey studies in the late 1970s to examine the role of the informal sector in employment and income generation in a number of metropolitan areas in Asia, Africa, and Latin America. These surveys revealed that between 20 and 70 percent of urban employment was found in the informal sector. In addition, the studies raised a number of important questions regarding the structure and composition of the informal sector, its impact on the environment, its capacity to absorb labor, the participation of women in the labor force, and the role of government in the economy.

Two important policy implications of this research have been promotion of non-farm employment, particularly in rural areas and small towns, and support of programs to contain population growth. In addition, emphasis has been placed on the need to facilitate informal sector access to skills, capital and technology either directly through international donor projects or through the LDC government. In other words, the "ILO approach" recommends direct government and international donor assistance to the informal sector through support of training and credit programs, and through development of infrastructural facilities. Support of small and micro- enterprises has also been a key component of these policies.

2. Formal-Informal Sector Linkages

An important and more recent approach to the study of the informal sector has focused attention on the nature of the relationship between the formal and the informal sectors. This approach has gone beyond explanations of the informal sector as employer of last resort to document more precisely the linkages between formal and informal sector activities.

To some extent, this "linkage approach" has arisen in response to criticisms that the dichotomous formal-informal framework used in many studies of the urban labor market overlooks the interrelationship and, in some views, the interdependence of the informal and formal sectors.

Recent studies have found that the informal sector is linked to an important degree to production and consumption in the formal sector, and that the principal mechanism through which these linkages occur is subcontracting. Moreover, evidence from case

studies in different cities in developing as well as developed countries suggests that the subcontracting relationships are often established by formal enterprises in an attempt to reduce labor costs in the context of an abundant labor supply, coupled with extensive and restrictive labor legislation. These studies also suggest that the informal sector itself is heterogeneous and that it must be segmented into at least two different, but interdependent groups: (a) informal laborers with no contractual arrangements or legal protection, and (b) informal "entrepreneurs and middlemen" who coordinate the activities of the former and establish the linkages with the formal sector. The earnings of the latter segment often are equal to or greater than those of their counterparts in the formal sector, while those of the former are usually lower.

These studies, however, also demonstrate that linkages between the formal and the informal sectors may vary significantly in both kind and degree depending on the country in question, and highlight the need to explore further the inter-links and integration of these sectors.

3. The "ILD Approach": The Informal Sector as Entrepreneur

The research of the Instituto Libertad y Democracia (ILD) in Peru has added a new dimension to the study of the informal sector. Its findings have contested the premise of earlier studies which view the informal sector primarily as a means for survival at the margins of the "modern" urban economy. In contrast to the ILO, for example, which finds that "informal sector units are not headed by entrepreneurs" and "their orientation is primarily employment rather than profit", the research of the ILD underscores the fact that informal sector participants are apparently entrepreneurial and democratic, and that they have opted out of the formal sector because of high transactions costs arising from "bad laws".

Thus, the "ILD approach" views the choice between working formally or informally as a rational process ensuing from analysis of the relative costs and benefits of formal sector participation in the context of a highly complex and inadequate legal and regulatory environment. It follows then that the low levels of growth of the economy arise from the "high costs of formality," which result in: low productivity due to inefficient specialization; low levels of productive investment; high taxes which discourage creation and expansion of business; and disincentives to technological progress and innovation. In short, the roots of underdevelopment can be traced to government policies and institutions which raise the costs of transactions required for participation in the formal economy, and encourage exit into the informal sector.

III. Key Themes in Informal Sector Literature

Opinions on the role and potential of the informal sector in economic development are varied and controversial. The controversy usually begins with the very definition of the informal sector and continues to sharpen when the policy implications are discussed. Nevertheless, there is widespread recognition and concurrence on the importance of studying the informal sector, however defined, and on exploring further the implications for economic development policy. A number of themes emerge from an overview of the literature. These include, but are not limited to, the following:

A. Heterogeneity of the Informal Sector

Although much attention has focused on the formal-informal sector dichotomy, an emergent and important theme is the heterogeneity of the informal sector itself. As mentioned in the previous section, the segmentation of the informal sector has been approached in some studies from the point of view of linkages with the formal economy. This results in two subgroups, one which manages the subcontracts with formal sector firms and one which is subordinate to this group. The differing relations with the formal sector are used to explain the different levels of income earned within the informal sector.

William House in his study of the informal sector in Nairobi offers a different perspective, while stressing the heterogeneity of the informal sector. House concludes that the informal sector is highly diversified, both with regards to productivity and earnings levels as well as motivation of the participants. He subdivides the informal sector into an "intermediate sector" comprised of "dynamic entrepreneurs" operating small manufacturing and business units, and a large body of "marginal" workers catering to the demands of poor urban consumers, and earning incomes well below the minimum required to satisfy basic household needs. For House, the policy question then becomes "how best to maximize the development potential of the intermediate sector" while minimizing the size of the marginal sector.

House's approach provides a "compromise view" to the opposing perspectives described in the previous section in which the informal sector is seen either as a manifestation of poverty or as a manifestation of the entrepreneurial spirit which is drowned by the maze of government policies and regulations.

The heterogeneity of the informal sector also arises from the segmentation of informal markets that results when tribal or kinship groups develop informal contractual arrangements within the group. This point, which is examined by Vijay Jagannathan in his book on informal markets in developing countries, will be developed later in the paper.

12

B. Linkages

The subject of linkages or interrelationships of the formal and the informal sectors is also a controversial topic. Because of the "hidden" nature of informal activities, the links with the formal sector are difficult to document and relatively few studies have as yet undertaken this arduous task. This subject also raises a number of difficult questions with important policy implications. A central one has been whether policies should aim at "formalizing" the informal sector or whether continued growth of the informal sector should be promoted and supported. Another question is whether policies should support an integrated development utilizing existing and potential linkages between the two sectors.

The question of linkages has been explored to some extent in the studies sponsored by the ILO. More recently, however, a number of case studies of cities in Latin America have described a variety of modes of "articulation" between the formal and the informal sectors. These studies, which are summarized in a recent article by Alejandro Portes and Saskia Sassen-Koob suggest that "exit" from the formal sector is often voluntary, and that there is a "fluid exchange" between the formal and informal sectors which challenges assumptions that participation in the informal sector is a "last resort" or shelter from poverty.

Recent literature on linkages has also focused on an apparent growth in the informal sector in developed countries, the causes or motivations of this growth, and the variety of linkages that exist between formal and informal sectors.

C. Measurement

Measurement of the informal sector, including its size and contribution to national income and employment is an important theme in the literature on informality. By its very nature, however, informality is difficult to measure and researchers have utilized a variety of methods based on the "traces" left in the economy by the informal sector.

One popular methodology has relied on discrepancies between aggregate monetary indicators to estimate the magnitude of informal sector activities. This approach, which assumes that informal sector transactions take place in cash, is based on comparisons of the ratio of currency to demand deposits in a particular period to a base period, when informal activities are assumed to be close to zero. This type of measurement, however, is very sensitive to the choice of base period and has often resulted in widely different estimates of informal activities in a particular country. Moreover, recent work by Janet Landa, on the ethnically homogeneous middleman groups (EHMGs), and by Vijay Jagannathan, on informal contractual arrangements in LDCs, questions the validity of the cash-based assumption. Both Landa and Jagannathan have found that

informal contractual arrangements among participants in this sector permit transactions based on credit. Consequently, utilizing the cash criterion to measure the magnitude of informal sector activities may result in underestimation of the extent, and hence the significance of these activities.

Although discussion of the various approaches to measurement of the informal sector is beyond the scope of this paper, review of the literature indicates that evidence on the magnitude of informal sector activities and their contribution to economic growth is still scanty, and that considerable room for development and refinement of research methodologies exists. Moreover, the application of varying methodologies, as well as the different definitions of informal sector on which the methodologies are applied, make impossible comparisons over time and across countries or regions.

D. Property Rights and Transaction Costs

The interrelationship between property rights and transaction costs has been a central theme of recent studies of the informal sector by de Soto, Landa, and Jagannathan. These studies have examined, to a greater or lesser extent, the nature and development of informal property rights and other contractual arrangements in response to incoherent laws or to inadequate protection and enforcement of laws.

Literature on property rights generally has been concerned primarily with the use and function of legal property rights in economic systems. An assumption has been that these rights are protected and enforced by the prevailing body of law. In many developing countries, however, as de Soto, Landa, and Jagannathan have noted, laws may be incoherent (in de Soto's view because of the mercantilist system and the politicization of laws and regulations), inefficient, and may or may not be enforced. In some countries, the proliferation of often contradictory laws is also a problem arising because laws may be "purchased" by special interest groups. In this context, property owners may be forced to resort to <u>informal</u> contractual arrangements to protect their property rights.

Such informal or extra-legal contracts or norms are clearly not administered by the formal legal system. In the case of Landa's study, such contracts are formulated and self-policed by ethnically homogeneous middleman groups in order to lower the cost of transactions that arise from economic exchange. In Jagannathan's book, informal contracts are made within tribal, kinship or other social groups. These contracts are based on mutual trust and cooperation among members of the same kinship or tribal group. In de Soto's book, these extra-legal norms are established and enforced by individuals pursuing "legal means in illegal ways" as a result of the high costs of entry into the

formal sector.

These informal contracts have important implications for the study of transaction costs and the efficiency with which resources are allocated in an economy. In his study, Jagannathan finds that informal contractual arrangements result in low transaction costs within these groups which permit a high degree of allocational efficiency within segments of the "unorganized" markets. According to Jagannathan, "[this] is possible because within segments positive externalities are generated by maintaining a desired pattern of behavioral relations without transactions costs." The costs of transactions between these groups or segments, however, are high, and result in varying degrees of inefficiency.

Landa finds that the creation of informal contracts among ethnically homogeneous middleman groups in Southeast Asia and Africa as a substitute for formal laws enables these middlemen to become successful entrepreneurs and to carry on their economic activities efficiently. However, because these arrangements limit the size of the middleman group, they result in inefficiencies when the costs of excluding "outsiders" are taken into account.

De Soto, who agrees with Landa's view that these arrangements are a "second best solution", sees the creation and enforcement of extra-legal norms among informal sector participants as evidence of their desire to become "formals".

A key policy implication of these studies is the significance of creating and enforcing efficient laws, which can lower the costs of transactions associated with participation in the formal economy and create incentives for entrance by the informals into the formal sector.

E. The Role of Laws and Institutions

Neo-institutional economists have drawn attention to the importance of the institutional framework in which economic production and exchange take place. Understanding this framework requires a blend of disciplines and research perspectives, including law and property rights, organizational theory, transaction cost economics, economic history, and public choice.

A central focus of the new institutional economics is the study of the impact laws and institutions have on economic exchange or trade through their effects on transaction costs. These transaction costs are basically the expenditures incurred by firms in the process of contract negotiation and enforcement. According to Dr. Ronald Coase, who laid the foundations of transaction cost economics, the institution of the firm emerges to economize on these transaction costs. In other words, transaction costs are significant determinants of the organization of economic activity.

When laws and institutions provide for the effective protection and enforcement of property rights and other contractual arrangements, transaction costs are zero, and markets are efficient. If, on the other hand, the legal framework is inadequate, as de Soto believes is the case in Peru and other LDCs, transaction costs are high and block the efficient development and operation of the market.

In the literature on the informal sector, the neo-institutionalist approach has been used to analyze the role laws and institutions play in encouraging/discouraging participation in the formal economy, and in discouraging/encouraging entrance into the informal economy. For Hernando de Soto, study of the institutional infrastructure is fundamental in understanding the causes of informality and underdevelopment in Peru and in other developing countries.

IV. Developing a Research Agenda

Of the themes identified in the previous section, three areas are suggested below as potential choices for the research agenda supported by AID. The overview of the literature on informality confirmed that the subjects discussed below, and identified in the November 1988 meeting of the "Working Group on Economic Institutional Reform" as important research questions, indeed constitute critical research gaps requiring further exploration. Moreover, as will be shown below, these topics are interrelated and complement the work of the ILD.

The first two subjects focus on the development of tools that can be used (a) to test the hypotheses of the ILD in other countries, and (b) to demonstrate the costs in terms of economic growth associated with highly politicized and inefficient systems of laws and regulations. The application of these tools in a variety of countries can have a powerful "demonstration" effect which can be utilized to convince governments and political constituencies of the importance of economic institutional reform. The last area is aimed at exploring and analyzing in a comparative historical perspective the ways in which institutional change has occurred in different countries.

A. Measurement

The application of conventional economic tools to measure economic growth fails to take into account the contributions of informal sector activities. Yet, as Dr. Jerry Jenkins has pointed out, "[t]he 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 .... 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."

An important part of the research program of the ILD in Peru has concentrated on the development of methods to identify and quantify informal activities. These findings, and those of other researchers, indicate that informality may be a widespread phenomenon. As mentioned in the previous section, however, the application of various methodologies to varying definitions of the informal sector prevent empirical confirmation of the magnitude of such activities and of their current and potential contribution to economic growth. The diversity of approaches also inhibits cross-national comparisons.

Additional research is needed that will support the development of new tools that can be applied consistently to different countries and regions to estimate the magnitude of the informal sector's participation in the economy. Research involving data collection in the field would be a natural progression to the exploration and development of measurement tools that can support a better understanding of informality in developing economies.

B. Transaction Costs

In the words of Oliver Williamson, "[t]ransaction costs are the economic equivalent of friction in physical systems." Applied in the context of informal economies, transaction costs translate into the costs of doing business in the formal sector. Because transaction costs are heavily influenced by the legal and institutional infrastructure that governs property rights and the exchange of these rights, they can be used as proxies to measure the costs of complying with regulations, and as a means to explore the relationship between these costs of doing business and the level of income or rate of economic growth.

The ILD, with advise from the Washington University in St. Louis, is currently engaged in the development of a methodology to measure the costs of transactions in different countries, using as a point of departure the costing procedures and estimates employed in The Other Path. The objective of this research activity is to develop a technique that can be applied in different countries, and used to compare costs and relate these to levels of economic development. In the long-term, the objective of this project is to address the following questions:

- How transaction costs vary across time and across countries;
- How transaction costs are related to the size and growth of the informal sector;
- How transaction costs relate to levels of income across

47

countries;

- How changes in transaction costs relate to changes in growth rates.

C. Institutional Reform

1. Comparative Studies

Research by the ILD and by neo-institutionalist economists has called attention to the role of legal and institutional systems in economic development. According to this view, an effective legal and institutional infrastructure facilitates economic growth by allowing entrepreneurs to engage in economic activities at the lowest costs possible. Conversely, inadequate and inefficient laws and institutions make the costs of doing business excessive, and so inhibit private initiative and economic growth.

The transaction cost approach described above provides one means of exploring the impact of regulations on economic activity and growth, and the requirements for institutional reform. A complementary research approach would be to examine the evolution of laws and institutions in comparative economic historical context. This research approach would draw on the literature of economic history to develop comparative studies of important institutional changes or "lessons learned" from the experience of developed and newly industrialized countries. It would also examine the costs and benefits of the different approaches as well as the policy implications.

2. Role of International Development Agencies in Institutional Reform

The ILD has been critical of the restructuring programs that debt-ridden countries are typically required to undertake by the International Monetary Fund and the World Bank on the grounds that these programs are short-sighted, "top-down" approaches which give little consideration to the political consequences of the policies they recommend. The ILD has also been critical of foreign aid programs, including private sector development programs, because in its view they confuse "mercantilists" with "non-elite entrepreneurs", and serve to strengthen the former.

The research agenda developed for this AID project must address these and other issues regarding the role of international development agencies vis-a-vis the informal sector, and must examine how these agencies can best support institutional reform. Accordingly, exploration of the policy implications and development of policy recommendations must be principal components of any of the suggested research topics.

V. Conclusion: The Informal Sector as Symptom and Solution

The views of the informal sector that emerge from a review of the literature paint different pictures of informality, some emphasizing the "marginal" nature, others the "entrepreneurial" qualities. All, however, have consistently underlined the resourcefulness and enterprise of informal sector activities. Invariably, these studies have also viewed informality as a symptom, a symptom of misguided government policies or of failed attempts at industrialization, or, as in de Soto's view, a symptom of "institutional dysfunction." Not all agree, however, on whether or not the informal sector is also the solution to these maladies, or at least part of the solution, and the implications and policy recommendations are varied.

Hernando de Soto does believe that the informal sector is the solution, but not as a "shock absorber" or employer of last resort which needs to be aided by governments and international agencies. He believes it is the solution in that it can help to illustrate and explain the causes of underdevelopment. In his words, "[t]he ILD posits that the study of informality and its causes holds the key to development in Latin America for several reasons." These reasons are:

- By examining which institutions the informals have opted out of, it is possible to identify the sources of institutional inefficiency.

- By studying the extra-legal norms created by the informals as a substitute for the law, it is possible to identify what the informals are voting for.

- The extra-legal institutions sanctified by the informals are eminently democratic, and the economic system they have devised is a nondiscriminatory market economy. Therefore, the informals constitute a large, national constituency favorable to participatory democracy and a market-led economy.

In this context, the research agenda for this AID project should aim at facilitating and advancing a better understanding of the informal sector through the development of tools that have practical applications in the field. The topics suggested in this paper can further this understanding in four important ways:

- By facilitating the measurement of the magnitude and hence importance of the informal sector;

- By promoting the development of tools to measure the costs associated with the growth of this sector;

- By supporting the development of comparative analyses that can contribute to a historically-based understanding of the role of institutions in economic development; and

- By encouraging the exploration of how international development agencies can best assist in the development process through support of economic institutional reform.

APPENDIX A:

ANNOTATED BIBLIOGRAPHY ON THE INFORMAL SECTOR AND ECONOMIC INSTITUTIONAL REFORM

THE INFORMAL SECTOR AND ECONOMIC INSTITUTIONAL REFORM ANNOTATED BIBLIOGRAPHY*

Acharya, S. "Unaccounted Economy in India - A Critical Review of Some Recent Estimates." Economic and Political Weekly 18, 49 (1983): 2057.
Not Available.

Acharya, S. and S. Madhur. "Informal Credit Markets and Black Money: Do They Frustrate Monetary Policy?" Economic and Political Weekly 18, 41 (1983): 1751-1756.
Not Available.

Amin, A.T.M. "The Role of the Informal Sector in Economic Development - Some Evidence for Dhakka, Bangladesh." International Labour Review 126, 5 (n.d.): 611-623.
This article is based on surveys conducted in Dhakka for the purpose of assessing the informal sector's potential in employment and income generation. It provides a comprehensive appraisal of the activities of this sector, its principal characteristics and its role in the process of industrial development. The article concludes that the informal sector offers income earning opportunities to large members of disadvantaged people, and that it has a major role to play in expanding the capacity of the nonagricultural sector to absorb labor and facilitating the eventual industrial transition of the economy. It calls for an end to legal regulatory impediments and review of government policies regarding the informal sector.

Anheier, H. and H.D. Seibel. Small Scale Industries and Economic Development in Ghana: Business Behavior and Strategies in Informal Sector Economies. Ft. Lauderdale: Beiternabach Publishers, 1987.
Not Available.

Aryee, George, "The Informal Manufacturing Sector in Kumasi." In The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment, ed. S.V. Sethuraman. Geneva: International Labour Office, 1981.
This study is based on a sample of informal manufacturing enterprises, especially fitting, tailoring and leather manufacturing. The study finds no direct linkages between the informal and formal sectors, but finds indirect linkages

---

* While recognizing the considerable overlap of informal sector and microenterprise studies, this bibliography omits literature which focuses specifically on microenterprise.

The bibliography was prepared by Flora M. Painter and Sandra Altamero, with research assistance from Maura Tucker.

through intermediaries in selected activities. A distinctive finding of the study is the ability of the Kumasi informal sector to absorb substantial quantities of labor in the form of apprentices.

Aziz, Abdul. Urban Poor and Urban Informal Sector. New Delhi: Ashish Publishing House, 1984.
Not Available.

Bagachwa, Mboya S.D. The Urban Informal Enterprise Sector in Tanzania. Dar es Salaam, Tanzania: Economic Research Bureau, University of Dar es Salaam, 1981.
Not Available.

Bakht, Farid and Raisul Mahmud. Overseas Remittances and Informal Financing in Bangladesh. Unpublished, May, 1987.
Not Available.

Banerjee, Biswajit. "The Role of the Informal Sector in the Migration Process: A Test of Probabilistic Migration Models and Labour Market Segmentation for India." Oxford Economic Papers 35 (1983): 399-422.
Not Available.

Banerjee, Nirmala. Women Workers in the Unorganized Sector. Hyderabad, India: Sangam Books, 1985.

Bardouille, Raj. Women's Economic Participation in the Urban Informal Sector. Lusaka. Manpower Research Unit, Institute for African Studies: University of Zambia, 1981.
Not Available.

Benton, Lauren A. "The Informalization of Spanish Industry: The Role of Unregulated Labor in Industrial Development." Research Report, Department of Anthropology, Washington, D.C., May 1984.

Bienefeld, M. "The Informal Sector and Peripheral Capitalism: The Case of Tanzania." Institute of Development Studies Bulletin (February 1975).

Biggs, Tyler, Merilee S. Grindle, and Donald R. Snodgrass. "The Informal Sector, Policy Reform, and Structural Transformation." In Beyond the Informal Sector: Including the Excluded in Developing Countries, ed. Jerry Jenkins, 133-179 San Francisco: Institute for Contemporary Studies (ICS) Press, 1988.
This paper argues that current interest on the informal sector is to a significant degree based on misinterpretation arising from differing definitions of the "informal sector". The authors find that questions regarding the informal sector need

53

to be refocused away from the sector itself and directly on the causes and consequences of low-productivity employment and on the impact of "ill-advised" government policies. The authors recommend that policies and programs on the informal sector focus on policy reform and structural transformation, rather than direct support to informal sector participants.

Birbeck, Chris. "Garbage, Industry, and the 'Vultures' of Cali, Colombia." In Casual Work and Poverty in Third World Cities, ed. R. Bromley and C. Gerry. New York: Wiley, 1979.

Boeschoten, W.C. The Volume of Payments and the Informal Economy in the Netherlands, 1965-1982. Kluwer Academic Publishers, 1984.

Breman, Jan. "A Dualistic Labour System? A Critique of the 'Informal Sector' Concept." In Planning for Small Enterprises in Third World Cities, ed. Ray Bromley. New York: Pergamon Press, 1985.
This article examines the origins of the informal sector concept and critiques the dualistic informal-formal sector framework.

Bromley, Ray. "Introduction--the Urban Informal Sector: Why Is It Worth Discussing." World Development 6 (September - October 1978): 1033-1039.
This article reviews the relevance of dualistic models of economic development to the study of the urban informal sector in LDCs. It focuses on the origins, diffusion and deficiencies of the formal/informal dualistic classification.

Bromley, Ray. "Organization, Regulation and Exploitation: The So-Called 'Urban Informal Sector': The Street Traders of Cali, Colombia." World Development 6 (September - October 1978): 1161-71.

Bromley, Ray, ed. Planning for Small Enterprises in Third World Cities. New York: Pergamon Press, 1985.
This book is a collection of studies on small and microenterprises, and the informal sector. It includes articles by E.F. Schumacher, Malcolm Harper, and Jeffrey Ashe.

Bromley, Ray. The Urban Informal Sector: Critical Pespective on Employment and Housing Policies. Oxford: Pergamon Press, 1979.
Not Available.

Chandavarkar, Anand G. "Informal Sector: Empty Box or Portmanteau Concept?" World Development (U.K.) 16 (October 1988): 1259-61.
This article attempts to prove that, if appropriately examined, the concept of the informal sector has analytic and

operational value as a portmanteau concept for employment, developmental and financial policies in LDCs based on testable hypotheses and properly designed qualitative studies.

Chandavarkar, Anand G. "The Informal Financial Sector in Developing Countries: Analysis, Evidence and Policy Implications." Occasional Papers No. 2, Kuala Lumpur: SEACEN Research and Training Centre, 1987.
Not Available.

Chandavarkar, Anand G. "The Role of Informal Credit Markets in Support of Microbusinesses in Developing Countries." Paper presented at the World Conference on "Support for Microenterprises", Washington, D.C., June 6-9, 1988.
This paper examines the role of informal credit markets in relation to microenterprises in LDCs. It draws on available research and field experience to develop policy recommendations.

Cheung, Steven N.S. "The Contractual Nature of the Firm." The Journal of Law and Economics 26, 1 (April 1983): 1-23.
This article shows the manner in which transactions costs are minimized in Hong Kong despite widespread subcontracting. The concepts developed in this article have applicability to the informal sector.

Cho, Uhn. Capital Accumulation, Women's Work and Informal Economies in Korea. East Lansing: Michigan State University, Office of WID, 1983.
Not Available.

Choe, J.H. (GE) "The Reciprocity Between the Formal and Informal Sectors - An Interpretation Based on Bibliographic Material from South Korea." Internationales Asien Forum 13(3-4) (1982): 269, 286.

Choucri, Nazli. "The Hidden Economy: A New View of Remittances in the Arab World." World Development 14, 6 (1986).
This article focuses on the hidden economy which emerges as a result of large-scale migration of labor in search of employment outside national boundaries. Remitted earnings are handled primarily through informal mechanisms and lead to the emergence of financial and economic networks that define the boundaries of the hidden economy. The article stresses the difficulties in measuring the size of the hidden economy. Special emphasis is given to Sudan and Egypt to illustrate the operations and principal features of the hidden economy.

Connolly, Priscilla. "The Politics of the Informal Sector: A Critique." In Beyond Employment: Household, Gender and Subsistence, eds. Nanneke Redclift and Enzo Mingione, 55-92. New York: Basil Blackwell Ltd., 1985.

This chapter discusses the practical implications of grouping a wide variety of phenomena under the category of informal sector. The author questions the usefulness of the informal sector concept as applied in relation to employment and labor conditions.

Danes, Sharon M. Informal and Formal Market Participation of Rural Honduran Women. East Lansing: Michigan State University, 1985.
Not Available.

Dasgupta, Biplab. "Calcutta's Informal Sector." Bulletin 5 Sussex: Institute of Development Studies, 1973.
This article provides an account of the congestion externalities caused by Calcutta's hawkers.

Davies, Rob. The Informal Sector. London: Catholic Institute for International Relations, 1978.

De Alessi, L. "Survey on Property Rights Literature." In Research in Law and Economics 2, ed. R.O. Zerbe, 1-44. Greenwich: Jai Press, 1980.
Not Available.

Dearanujo, T.P., Neto, L.G., and A.D. Souza. "Employment Implications of Informal Sector Policies - A Case Study of Greater Recife." International Labour Review 127, 2 (1988): 243-258.
Not Available.

De Soto, Hernando. "Constraints on People: The Origins of the Underground Economy and Limits to Their Growth." In Beyond the Informal Sector: Including the Excluded in Developing Countries, ed. Jerry Jenkins, 15-47. San Francisco: Institute for Contemporary Studies (ICS) Press, 1988.
This paper summarizes the findings of the ILD regarding the informal sector and the legal and regulatory impediments to economic growth in Peru.

De Soto, Hernando. El Otro Sendero: La Revolución Informal. 4th ed. Bogota, Colombia: Editorial La Oveja Negra Ltda., 1987.
This study of the informal economy in Peru describes the magnitude and complexity of extralegal economic activities in the country. It provides a new and polemical interpretation of the causes of underdevelopment and stresses the importance of institutional reform to overcome the legal and regulatory barriers which foster informality and inhibit economic growth.

De Alessi, Louis. "Survey on Property Rights Literature." In Research in Law and Economics 2, ed. Richard O. Zerbe, 1-44. Greenwich: Jai Press, 1980.

56

Demol, E. and G. Niha. "The Modern Informal Sector in Yaounde." International Labour Review 121, 1 (1982): 77-78.
This article summarizes the findings of a census and survey of the informal sector in Yaounde. The census covered all economic activites in this sector except for building and transport. The article describes the informal sector's contribution to the national economy in terms of employment, income and transmission of skills.

Fapohunda, O.J. "Human Resources and the Lagos Informal Sector." In The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment, ed. S.V. Sethuraman, 70-82. Geneva: International Labour Office, 1981.
This study is based on a survey of 2000 enterprises, primarily in the manufacturing and service industries. Its principal focus is the utilization and development of human resources in the informal sector.

Feige, E.L. "How Big is the Irregular Economy?" Challenge 22 (November - December, 1979): 5-13.

Fowler, D.A. "The Informal Sector in Freetown: Opportunities for Self-Employment." In The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment, ed. S.V. Sethuraman, 51- 69. Geneva: International Labour Office, 1981.
This study is based on data compiled from 967 informal enterprises in the manufacturing, construction, trade, transport, and services sectors. It shows that urban migration is closely linked to the growth of the informal sector.

Gaughan, Joseph P. and Louis A. Ferman. "Toward an Understanding of the Informal Economy." The American Academy of Political and Social Science, Annals 493 (September 1987): 15-25.
This article is an anthropological/sociological exploration of the causes and nature of the informal sector. It argues that the informal economy has not developed simply because there is a failure in traditional economic systems of distribution. Instead, the article finds that the informal economy is based on family and community relations which stress mutual obligation and reciprocity, and may not involve an immediate expectation of financial return.

Gerry, C. "Developing Economies and the Informal Sector in Historical Perspective." The American Academy of Political and Social Science, Annals 493 (September 1987): 100-119.
This article traces the relationship between the informal economy and socioeconomic development back to the early 19th century. It argues that interest in the informal sector has fluctuated according to the cycle of boom and slump in national international economies. Study of this broader historical context is essential to develop an adequate

understanding of the nature and causes of informal economic activites.

Gray, Jane. Conference on the Comparative Study of the Informal Sector, Harper's Ferry, West Virginia, 1986. International Journal of Urban and Regional Research (U.K.) 11 (September 1987):421-423.
This article is a summary of themes discussed during a conference which brought together scholars from the United States, Europe, Africa, Asia and Latin America with the purpose of exploring and promoting a broader understanding of the causes and consequences of the informal economy worldwide. The principal themes discussed included: the linkages between the formal and the informal sector; the heterogeneity of the informal sector; the interaction of the informal sector with household survival strategies; and the state's role in the process of informalization.

Guisinger, Stephen, and Mohammed Irfan. "Pakistan's Informal Sector." Journal of Development Studies. (July 1980).

Gutmann, P. M. "Statistical Illusions, Mistaken Policies." Challenge 22 (November-December, 1979): 14-17.

Hammer, H.R. and C. Manuel (GE) "An Economic Analysis of the Urban Informal Sector." Jahrbuch fur Sozialwissenschaft 39(1-2) (1988): 297-312.
Not Available.

Harriss, Barbara. "Quasi-Formal Employment Structures and Behaviour in the Unorganized Urban Economy and the Reverse: Some Evidence from South India." World Development 6 (1978):1077-1086.
This article examines the structure of the labor markets in the "organized" and "unorganized" sectors of urban economies in South India to determine whether differences between the two sectors are significant enough to warrant their separate study. The study finds considerable overlap between the two sectors and questions the validity of using the formal/informal dichotomy for analytical purposes.

Hart, Keith. "Informal Income Opportunities and Urban Employment in Ghana." The Journal of Modern African Studies II, I (1973): 61-89.
This article describes the informal economic activities of low income laborers who have migrated from Northern Ghana to the Southern area of Accra. The author finds a high degree of informality in the income-generating activities of this group, and proposes that income and expenditure patterns are more complex than is normally allowed for in the economic analysis of developing countries. In response to the question of whether informal economic activities possess some autonomous

58

capacity for generating growth in the incomes of the urban poor, the author responds that much more empirical research is required

Henry, S. "The Political Economy of Informal Economies." The American Academy of Political and Social Science, Annals 493 (September 1987): 137-172.
This article considers the interrelationship between informal economies and the wider political economy of capitalism. It argues that as a result of these complex interrelations, the development of and intervention in informal economies is neither simple nor linear, and that failure to take these relations into account can lead to inappropriate policies with unforeseen outcomes.

Hofmann, Michael. "The Informal Sector in an Intermediate City: A Case in Egypt." Economic Development and Cultural Change 34,2 (1986): 263-277.
This article examines the nature and causes of growth of the informal sector in the context of overurbanization in Egypt.

House, William J. "Nairobi's Informal Sector: Dynamic Entrepreneurs or Surplus Labor." Economic Development and Cultural Change 32, 2 (January 1984): 277-302.
This article is based on a survey of informal sector enterprises in Nairobi in mid-1977. The results of the survey are used to test some general hypotheses about the informal sector. The paper demonstrates that Nairobi's informal sector is diversified in terms of productivity and income levels generated and in the motivation of the participants. The author finds that the division of the urban economy into formal and informal sectors is simplistic and inadequate. He finds at least two subsectors within the informal sector: an intermediate sector comprised of enterprising individuals generating adequate incomes, and "the commmunity of the poor" comprised of residual and underemployed laborers.

International Labour Office. The Structure of the Informal Sector in Mongu (Western Province) and its Potential for Employment Creation. Lusaka, Zambia: International Labour Office, 1982.
This study's objectives were to: 1) determine the size and structure of the urban informal sector in Mongu; 2) analyze constraints for its development; and 3) identify feasible areas of assistance to informal sector units from the view of creating more employment in the sector. It also addresses formal/informal sector linkages and provides a historical overview of the rise of the informal sector in Mongu.

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.
Not Available.

Jamal, V., ed. The Informal Sector in Africa, Synthesis and Country Summaries. Geneva: International Labour Office, 1984.
This study focuses on the role of the informal sector in economic development, especially its employment potential, its evolution with regards to productivity, and the role of government vis-a-vis this sector. It discusses the importance of linkages as mechanisms for transmitting growth from the formal to the informal sector.

Jagannathan, N. Vijay. Informal Markets in Developing Countries. New York: Oxford University Press, 1987.
The essence of this study is the creation and use of informal property rights in production and market exchange. The book examines both the forms and substance of informal contracts and the institutional consequences of these relations. By creating "expected utility", these informal contracts act as sources of wealth generation during the processes of production or exchange.

Jenkins, Jerry, ed. Beyond the Informal Sector: Including the Excluded in Developing Countries. San Francisco: Institute for Contemporary Studies (ICS) Press, 1988.
This is a publication by the Sequoia Institute resulting from a series of papers presented during a seminar in 1987. The book is part of a series sponsored by the Agency for International Development. It examines key characteristics of the informal sector and its causes as well as its potential role in economic development.

Johnny, Michael. Informal Credit for Integrated Rural Development in Sierra Leone. Hamburg: Verlag Weltarchiv, 1985.

Jules-Rosette, Bennetta. Women's Work in the Informal Sector. East Lansing: Michigan State Univeristy, 1982.

Kamya, Andrew. "Factors Affecting Efficiency in the Informal Sector in Lusaka and Kitwe." Lusaka: International Labour Organization, World Employment Programme, Southern African Team for Employment Promotion, 1981.
The major conclusions of this study are: the informal sector's major objective is employment generation rather than profit maximization; strong linkages exist between the formal and informal sectors in these two urban areas; inefficiencies result from a combination of low levels of education, negative attitudes on the part of young and middle-aged laborers; inadequate infrastructure, and non-optimal combinations of the factors of production.

6°

Khan, Shaheen. An Assessment of Changes in the Informal Sector of Employment. Lahore: Punjab Economic Research Institute, 1981.
Not Available.

Khundker, Nasreen. "The Fuzziness of the Informal Sector: Can we Afford to Throw Out the Baby with the Bath Water." World Development 16, 10 (1988):1263-1265.
This article argues that although a clear, uniform definition of the informal sector does not exist, it serves a useful purpose for organizing research and answering questions about the lower social strata.

Kilby, Peter, ed. Entrepreneurship and Economic Development. New York: The Free Press, 1971.
Not Available.

Koo, H. and P.C. Smith. "Migration, the Urban Informal Sector and Earnings in the Philippines." Sociological Quarterly 24,2, University of Hawaii (n.d.):219-232.
This article is the result of analysis of cross-sectional national demographic data. The principal findings are: the patterns of migrant participation in the urban labor market vary greatly between male and female migrants; the informal sector must not be identified with urban poverty; the effects of having a rural background and involvement in the informal sector seem to vary between Manila and secondary cities; and occupational mobility opportunities in Filipino cities, not sectoral boundaries, seem to constitute a significant mobility barrier.

Landa, Janet T. "A Theory of the Ethnically Homogeneous Chinese Middleman Group: An Institutional Alternative to Contract Law." The Journal of Legal Studies 10 (1981):349-362.
This articles develops a theory of the ethnically homogeneous middleman group (EHMG) in the context of an exchange economy characterized by contract uncertainty. It argues that the informal arrangements among the EHMG are an alternative to contract law and to the vertically integrated firm, which rose to economize on the costs of contract enforcement and information.

Landa, Janet T. "Underground Economies: Generic or Sui Generis?". In Beyond the Informal Sector: Including the Excluded in Developing Countries, ed. Jerry Jenkins, 75-103. San Francisco: Institute for Contemporary Studies (ICS) Press, 1988.
This paper provides evidence that an informal sector as described by Hernando de Soto is not unique to Latin America but is part of a general phenomenon found in developing countries with an underdeveloped legal framework. The author finds the most prominent examples of this phenomenon in

61

trading sectors dominated by foreign ethnically homogeneous middleman groups (EHMGs) such as the Chinese in Southeast Asia, the Indians in East and Central Africa, the Lebanese in West Africa, and the Jews in Medieval Europe. Landa finds that these EHMGs use informal (cultural) norms of behavior as substitutes for formal contract law and for the enforcement of these contracts.

Liedholm, Carl, and Enyinna Chuta. The Economics of Rural and Urban Small-Scale Industries in Sierra Leone, Rural Economy Paper No. 14, East Lansing, Michigan State University, 1976. Not Available.

Lozano, B. "Informal Sector Workers - Walking Out the System's Front Door." International Journal of Urban Studies 7, 3 (1983): 340-362.

Mabogunje, A.L. and M.O. Filani, "The Informal Sector in a Small City: The Case of Kano (Nigeria). In The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment, ed. S.V. Sethuraman, 82-89. Geneva: International Labour Office, 1981.
This study casts light on the implications to the environment of informal sector activities and emphasizes the necessity of integrating urban development policies and employment generation.

Mazumdar, Dipak. "The Urban Informal Sector." World Development 4, 8 (1976): 655-679.
This paper questions some of the conventional wisdom concerning the informal sector. The article finds that the informal sector is not the major point of entry for fresh migrants from rural areas and there exist large variations in earnings within it. A disproportionately large number of informal sector workers are (a) very young or very old, (b) females, (c) limited in education and (d) not the primary household earners. Finally, the paper confronts the predictions of a dualistic urban labour market model for trends over time in output, employment, productivity and earnings, with the results of a case study of Peru by Richard Webb.

Mehta, M. "Urban Informal Sector - Concepts, Indian Evidence and Policy Implications." Economic and Political Weekly 20, 8 (1985): 326-332.
Not Available.

Miller, S.M. "The Pursuit of Informal Economies." The American Academy of Political and Social Science, Annals 493 (September 1987): 26-35.
This article examines four different approaches to studying the informal economy and stresses the considerable differences

that exist between informal economies in different countries. It also provides an overview of different policy alternatives for dealing with the informal sector.

Miracle, Marvin, Diane S. Miracle and Laurie Cohen. "Informal Savings Mobilization in Africa." Economic Development and Cultural Change (July, 1980).
This article examines current evidence on the nature of savings institutions in the informal sectors of African economies. It finds that the African informal sector is larger than previously thought based on a study of resource mobilization.

Mittar, Vishwa. Growth of the Urban Informal Sector in a Developing Economy. New Delhi: Deep & Deep Publications, 1988.
This study tries to identify how income and employment are generated in the informal sector and the principal constraints to enter the formal sector. Considerable attention is given to studying the formal-informal sector linkages.

Mizrahi, R. (SP) "The Economies of the Informal Sector - Dynamics of Small Enterprises and Their Viability." Journal of Anthropological Studies, Nippon 95, 2: 253.

Mkandawire, P. Thandika. The Informal Sector in the Labour Reserve Economies of Southern Africa with Special Reference to Zimbabwe. Harare: Zimbabwe Publications Office, ZIDS, 1985.

Moser, Caroline O.N. "Informal Sector or Petty Commodity Production: Dualism or Dependence in Urban Development?" World Development 6, 9/10 (1978): 1041-1064.
This article provides a critical review of the informal sector debate in recent studies of poverty and employment in developing countries. It identifies limitations of the dualist concept, both as a theoretical concept and as a basis for policy recommendations. An alternative model is recommended based on petty commodity production.

Nicholls, William M. The Informal Economy. Ottowa: VIF Publications, Canada, Publication Renouf Distribution, 1983.
Not Available.

North, Douglass C. "The New Institutional Economics." Journal of Institutional and Theoretical Economics 142 (1986): 230-237.
This article examines the premises of institutional economics and describes the basic building blocks of a theory of institutions: (a) individuals maximize their utility; (b) measurement costs of contracting are high; (c) costs of enforcement are critical; (d) the structure and evolution of political institutions changes and defines property rights and their enforcement; (e) individuals preferences and ideology

63

are important. The article highlights the necessity of combining transactions costs, property rights, and public choice theories. These propositions have applicability to the informal sector.

Pahl, R.E. "Some Remarks on Informal Work, Social Polarization and the Social Structure." International Journal of Urban and Regional Research (U.K.) 12 (June 1988): 247-67.

Papola, T.S. Urban Informal Sector in a Developing Economy. New Delhi, India: Vikas Publishing House Pvt. Ltd., 1981.
This study examines the proposition that a development strategy focusing on the informal sector could prove effective in the generation of rapid and equitable growth of income and employment. The assumptions and implications of this proposition are tested against empirical evidence arising from a study by the author of the informal sector in Ahmedabad, India.

Park, Yung Chul. "The Unorganized Financial Sector in Korea 1945-1978." World Bank, Finance Studies 28, Washington, D.C.

Peattie, L. "An Idea in Good Currency and How it Grew - The Informal Sector." World Development 15, 7 (n.d.): 851-860.
This article focuses on the question of definition of the informal sector. Although it finds that it use has been helpful in directing attention to phenomena previously ignored, the term obscures analysis of central issues and is counterproductive. The author proposes that critical policy issues should be specified instead and thereby field research designed.

Pinnaro, Gabriella and Enrico Pugliese. "Informalization and Social Resistance: The Case of Naples." In Beyond Employment: Household, Gender and Subsistence, eds. Nanneke Redclift and Enzo Mingione, 228-248. New York: Basil Blackwell Ltd., 1985.
This study examines the deep-rooted traditions of informal sector activities in Naples. It examines informality from the point of view of "resistance" to state regulation of "productive and reproductive" activities.

Portes, Alejandro, Silvia Blitzer, and John Curtis. "The Urban Informal Sector in Uruguay: Its Internal Structure, Characteristics, and Effects." World Development, 14, 6 (1986): 727-741.
The literature on urbanization in LDCs has focused on the informal sector as a mechanism to explain the survival strategies of the poor excluded from regular employment and the strategies of formal firms to bypass regulatory constraints and reduce costs. This paper pursues these lines of research in the context of Uruguay.

Portes, Alejandro, Manuel Castells, and Lauren A. Benton. The Informal Economy: Studies in Advanced and Less Developed Countries. Baltimore: Johns Hopkins University Press, Forthcoming March 1989.
This book is the result of a project begun in 1981 to assess informal economies in more than 20 cities in 5 continents. The book will contain essays from 19 contributors.

Portes, Alejandro and Saskia Sassen-Koob. "Making It Underground: Comparative Material on the Informal Sector in Western Market Economies." American Journal of Sociology 93,1 (July 1987): 30-61.
This article examines the informal economy and its relationship to commonly held theories of industrial development. The assumption in most of these theories that widespread informal sector activities are primarily a Third World phenomenon arising from poverty, and that such activities will disappear with the advance of modernization, is questioned by evidence presented in the article. Alternative interpretations of the resilience of these activities in LDCs, despite rapid industrialization, and their continuity and apparent revival in the advanced economies are discussed.

PREALC, International Labour Organization. Cambio y Polarización Ocupacional en Centroamérica. Costa Rica: Editorial Universitaria Centroamericana, 1986.
This book examines the modernization process in Central America in the three decades prior to the economic crisis and its effects on the labor market. It includes a chapter on the urban informal sector in the context of partial modernization. This chapter examines the growth and evolution of the informal sector in the 1950-80 period, its structure and composition, and the principal impediments to the development of this sector.

Romatet, E. "Calcutta Informal Sector - Theory & Reality." Economic and Political Weekly 18, 450 (1983): 2115-2128.
Not Available.

Ross, David and Peter J. Usher. From the Roots Up: Economic Development as if Community Mattered. New York: The Bootstrap Press, 1986.
This book tries to analyze, measure and describe the characteristics of the informal economy in Canada. The authors contrast the formal and informal sectors in terms of purpose and social function, and suggest changes in economic policies to strengthen the informal sector.

Roumasset, J.A. and S. Simons. "A Transaction Cost Model of Formal and Informal Markets for Rural Credit." American Journal of Agricultural Economics 68, 5 (n.d.): 1377.

This paper develops a model which describes formal and informal rural credit markets in terms of transaction costs of lenders. Stimulating agricultural investment with subsidized formal loans is shown to incur significant efficiency costs by drawing credit away from high productivity investments in the unsubsidized sector.

Sanchez, Vicente. "Estructuras de lo cotidiano y funcionamiento de la "economía real" en las ciudades: más allá de la dicotomía formal-informal. Revista Interamericana de Planificación. Sociedade Interamericana de Planificación (International) 22 (January-March 1988): 8-17.
Not Available.

Schneider, Friedreich. The Development of the Shadow Economies for Denmark, Norway and Sweden. Arrhus, Denmark: Institute of Economics, University of Aarhus, 1986.

Seiber, H.D., and M.T. Marx. Dual Financial Markets in Africa: Case Studies of Linkages Between Informal and Formal Financial Institutions. Ft. Lauderdale: Breitenbach Publishers, 1987.
Not Available.

Sethuraman, S.V. "Basic Needs and the Informal Sector - the Case of Low-Income Housing in Developing Countries." Habitat International 9, 3-4 (n.d.): 293-316.
Not Available.

Sethuraman, S.V. "The Informal Sector in Indonesia: Policies and Prospects." International Labour Review 24, 6 (November-December 1985): 719-735.
This article finds that over half of all non-agricultural laborers in Indonesia are engaged in the informal sector, mainly in the cities and largely in the trade and services sectors. It points out, however, that many lack essential facilities to exercise their activities and have very low levels of income. If the informal sector is to continue to play a significant role in absorbing labor, policy-makers must take steps to facilitate this sector's access to credit, training, technology and raw materials. They must also strengthen the links between the informal and formal sectors, and encourage the former to enter productive activities in the manufacturing and construction sectors.

Sethuraman, S.V. "Urban Informal Sector in Africa." International Labour Review (November-December 1977).

Sethuraman, S.V., ed. The Urban Informal Sector in Developing Countries. Geneva: International Labour Office, 1981.
This book is a collection of studies conducted under the auspices of the ILO with the objective of identifying appropriate measures for promoting urban employment and the

66

environment on the one hand, and to improve the incomes of the urban poor on the other. It is the largest survey of the informal sector undertaken using a common methodology. The studies were conducted in the major cities of selected Asian, African, and Latin American countries, including Freetown (Sierra Leone), Lagos and Kano (Nigeria), Kumasi (Ghana), Colombo (Sri Lanka), Jakarta (Indonesia), Manila (The Philippines), Cordoba (Argentina), and Campinas (Brazil). The principal issues dealt with in the studies are: the conditions under which the informal sector absorbs labor and generates income; the implications to the urban environment of promoting the informal sector; the linkages between formal and informal sectors; the evolution over time of informal enterprises; and the productive efficiency of the informal sector.

Shaw, A. "The Informal Sector in a Third World Urban Economy: A Case Study of Calcutta, India." Bulletin of Concerned Asian Scholars 17, 1 (1985): 42-53.
This paper examines whether linkages between the informal and formal sectors result in a net transfer of value from the informal sector, ie. a) to what extent does the informal sector serve as a source of undervalued goods and services for the formal sector and b) by what specific mechanisms is value transferred from the informal to the formal sector. Analysis of Calcutta's urban economy indicates the vital roles of both wage subsidies and unequal trade in the process of value transfer from informal to formal sectors.

Silva, N.D., and A.D. Souza (PT). "Intersectorial Mobility and Homogeneity of the Informal Sector: the Case of Brazil." Revista Brasileira Economica 38(4) (1984): 327-356.

Simon, D. "Informal Sector Research: Note and Comment." South African Journal of Economics 49, 3 (1981): 295-298.
This article provides a critique of papers on the informal sector by Truu, Black, Zarenda, Rogerson and Beaven, and suggests appropriate avenues for future research. In particular, it recommends that research should focus on the strength and nature of linkages between the formal and informal sectors.

Simon, D. "Urban Poverty, Informal Sector Activity and Intersectorial Linkages - Evidence from Windhoek, Namibia." Development and Change 15, 4 (1984): 551-576.
This article examines linkages and related issues regarding the characteristics of the informal sector entrepreneurs, their motivations, returns and desires for the future in Windhoek. A chief contention is that informal urban economic activity largely represents a response to poverty, under- or unemployment, or lack of job security.

Smith, James D. "Measuring the Informal Economy." The American Academy of Political and Social Science, Annals 493 (September 1987): 83-99.
This article provides the results of a study on the informal economy in the United States based on a survey of about 2100 families. The most distinctive feature of this study is that it provides a systematic estimate of the size of the informal economy. The approach used was to measure the value of purchases households made from informal vendors. The study describes the scope and procedures for measuring the informal economy and the difficulties encountered.

Smith, Stephen. Britain's Shadow Economy. Oxford: Clarendon Press, 1986.
This book considers a variety of different activities within the "hidden" economy, from moonlighting and tax dodging to household activities such as baby-sitting, cleaning, and so forth. Measurement of the shadow economy is an important issue discussed in the book.

Souza, P.R., and V.E.Tokman. "The Informal Urban Sector in Latin America." International Labour Review 114 (November-December 1976): 355-365.
This article analyzes the nature of the informal urban sector and the characteristics of those who work in it in an attempt to understand the sector's present and potential contribution to employment. To assess the sector's participation in the urban economy, the authors rely on census and household survey data and more detailed information collected by PREALC. The study stresses the need for specific employment policies to enlarge the markets and raise the income and productivity levels of the informal sector.

Stearns, Katherine E. "Assisting Informal-Sector Microenterprises in Developing Countries." Cornell University, Department of Agricultural Economics, International Agricultural Economics Study No. 85. Ithaca, New York (August 1985): 1-78.
Not Available.

Suarez, Berenguela, Ruben M. Informal Sector, Labor Markets and Returns to Education in Peru. Washington D.C.: USA Development Research Department, The World Bank, 1988.
Not Available.

Sullivan, John D., ed. Building Constituencies for Economic Change: Report on the International Conference on the Informal Sector. Washington, D.C.: Center for International Private Enterprise, 1987.
This document is a compilation of the papers presented during the first International Conference on the Informal Sector sponsored by the Center for International Private Enterprise. The conference, which was held October 26-27, 1987, brought

together 250 business, political and academic leaders from 35 countries. The theme of the conference was the political and economic clout that the entrepreneurs of the informal sector can wield in the developing world today.

Sundaram, K., and V. Pandit. "Informal Credit Markets, Money and Monetary Policy - Some Analytical and Empirical Issues." Economic and Political Weekly 19, 16 (n.d.): 675.
Not Available.

Tanzi, Vito, ed. The Underground Economy in the United States and Abroad. Lexington, MA: D.C. Heath and Company, 1982.
This book is a compilation of articles on the underground or informal economy in the United States and selected countries in Europe, as well as in Colombia, Israel and Australia. A number of chapters grapple with the question of definition of the informal sector. The most distinctive feature of this study, however, is the attempt to measure the magnitude of the underground economy in several countries. The many different methods of estimation are discussed throughout the book.

Teilhet, Waldorf S., and W.H. Waldorf. "Earnings of Self-Employed in an Informal Sector: A Case Study of Bangkok." Economic Development and Cultural Change 31, 3 (1983): 587-608.
This study attempts to establish if facts are consistent with the description and predictions of work behavior in the informal sector, particularly as theorized by economists. It summarizes the findings of job histories of the self-employed in three occupational groups in a Bangkok neighborhood: vendors, people working with bricks, and shopkeepers.

Tendler, Judith. "The Remarkable Convergence of Fashion on Small Enterprises and the Informal Sector: What Does it Mean for Policy? A Proposal." Cambridge: Massachusetts Institute of Technology. Mimeo.
Not Available.

Tendler, Judith. Ventures in the Informal Sector and How They Worked Out in Brazil. Washington, D.C.: USAID Special Study, 1983.
Not Available.

Thongrot, Onchan. Informal Credit and the Development of Non-farm Enterprises in Thailand. (Microfilm), Bangkok: USAID/Thailand, 1985.

Timberg, T.A., and D.V. Aiyar. "Informal Credit Market in India, World Bank Domestic Finance Studies 62." Economic Development and Cultural Change 33, 1 (1980): 43-59.
This study is based on an extended survey of some of the informal credit markets of India. The article identifies key characteristics of the intermediaries in this market which

seem to lead to lower transactions costs. These include: intermediaries' intimate knowledge of their clients which reduces their information costs versus those of commercial banks; absence of government control on lending and borrowing rates governing the intermediaries; and absence of charges on the informal intermediaries in the form of idle or low interest reserves.

Todd, D.C., and C. Shaw. "The Informal Sector and Zambia Employment Crises." Journal of Modern African Studies 18, 3 (1980): 411-425.
This article provides relevant data concerning a number of issues vital to the implementation of any measures to encourage self-employment in the informal sector of the Zambian economy. In particular, it attempts to quantify the likely flows into the labor force, particularly from the educational system, the possible growth of formal wage employment in urban areas, and the current size and composition of the informal sector.

Tokman, Victor E. "An Exploration into the Nature of Informal-Formal Sector Relationships." World Development 6, 9/10 (1978): 1065-1075.
This article analyzes the crucial question of interrelationships between the informal sector and the rest of the economy. Two principal approaches are discussed: one which assumes that favorable relations exist between the two sectors and one which assumes that subordination of the informal sector is the main characteristic of these relations. The author offers a new approach which assumes "heterogenous subordination", implying a subordinated relationship for the informal sector as a whole, but resulting from different processes occurring within it. Given such a framework, the paper predicts a declining trend in the share of income for the informal sector as a whole, but not leading to disappearance of the sector.

Trager, Lillian. "From Yams to Beer in a Nigerian City: Expansion and Change in Informal Sector Trade Activity." Markets and Marketing. Monographs in Economic Anthropology (4). Lanham, MD: University Press of America, 1985.
Not Available.

Truu, M.L., and P.A. Black. "The Urban Informal Sector and Market Imperfections." South African Journal of Economics 41, 1 (1980):12-27.
This article finds that prevailing market imperfections in the formal sector of a dual economy are an important cause of the expansion of the informal sector. It considers the expansion of the informal sector as a function of market imperfections, attempts an assessment of the informal sector's general economic significance, and discusses some policy implications.

76

Twum-Baah, Kwaku A. Income and Earning Structure in the Informal Sector. Chapel Hill: University of North Carolina Population Center, 1982.
Not Available.

Watanabe, Susumu. "Technological Linkages Between Formal and Informal Sectors of Manufacturing Industries." International Labour Office, World Employment Research Programme, Working Paper 34, 1978.

Weeks, John. "Policies for Expanding Employment in the Informal Urban Sector of Developing Economies." International Labour Review (January 1975).
This article tries to provide an analytical base to the highly descriptive nature of the distinction between the formal and the informal sectors. The author finds that the main distinguishing feature between the two sectors arises from their different positions vis-a-vis the State. The differential impact and enforcement of government regulation is thus a key factor in the informal-formal dichotomy.

Weeks, John. "Policies for Expanding Employment in the Informal Urban Sector of Developing Countries." In International Labour Review (January 1975).

Weeks, John. "Uneven Sectoral Development and the Role of the State." Institute of Development Studies Bulletin 5 (1973): 76-82.
Not Available.

Wellings, P., and M. Sutcliff. "Developing the Urban Informal Sector in South Africa: The Reformist Paradigm and Its Fallacies." Development and Change 15, 4 (1984):517-550.
This article addresses the causes for renewed interest in the urban informal sector on the part of governments and "reformist" academics. It also explores the feasibility of specific suggestions for the development of the informal sector.

Zarenda, H. "Imperfections in the Urban Informal Sector Market Model." South African Journal of Economics 48, 3 (1980):297-305.
This article critiques the analysis and conclusions of Truu and Black as well as the vast array of preconceptions and generalizations of the informal sector. According to the author, the only valid generalization is that the informal sector in LDCs has grown in reaction to abject poverty, and denial of various welfare benefits that are enjoyed by people in more prosperous countries.

APPENDIX B:

SELECTED BIBLIOGRAPHY ON TRANSACTION COSTS

SELECTED BIBLIOGRAPHY ON TRANSACTION COSTS

Alchian, A. and H. Demsetz. "Production, Information Costs, and Economic Organization." American Economic Review 62 (December 1972): 777-795.

Barzel, Y. "Measurement Cost and the Organization of Markets." Journal of Law and Economics 25 (April 1982): 27-48.

Cheung, N.S. "Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements." Journal of Law and Economics 13 (April 1969): 49-70.

Coase, R. "The Nature of the Firm." Economica 4 (November 1937): 386-405.

Coase, R. "The Problem of Social Cost." Journal of Law and Economics 3 (1960): 1-44.

De Alessi, Louis. "Property Rights, Transactions Costs and X-Efficiency." American Economic Review 73, 1 (March 1983): 64-81.

De Alessi, Louis. "The Role of Property Rights and Transaction Costs: A New Perspective in Economic Theory." Social Science Journal 3 (July 1983): 59-70.

Eggertson, T. Economic Behavior and Institutions: Principles of Neoinstitutional Economics. Cambridge University Press, 1988.

Jensen M. and W. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure." Journal of Law and Economics 3 (October 1976): 305-360.

Leff, N.H. "Externalities, Information Costs, and Social Benefit-Cost Analysis for Economic Development: An Example from Telecommunications." Economic Development and Cultural Change 32 (January 1984): 255-276.

North, D.C. " Institutions, Transaction Costs, and Economic Growth." Economic Inquiry 25 (July 1987): 419.

North, D.C. "Government and Cost of Exchange in History." Journal of Economic History 44, 2 (June 1984): 255-264.

North, D.C. and J.J. Wallis. "Measuring the Transaction Sector in the American Economy, 1870 - 1970." In Long Term Factors in American Economic Growth 51, Income and Wealth Series, eds. J. L. Engerman and R.E. Gallman. Chicago: University of Chicago Press, 1986.

North, D.C. "Sources of Productivity Change in Ocean Shipping,

1600 - 1850." Journal of Political Economy (1968).

North, Douglass C. Structure and Change in Economic History. New York: Norton, 1982.

Pollak, Robert A. "A Transaction Cost Approach to Families and Households." Journal of Economic Literature 23, 2 (June 1985): 581-608.

Saito, K.A. and D.P. Villaneuva. "Transaction Costs of Credit to the Small-Scale Sector in the Phillipines." Economic Development and Cultural Change 29, 3 (April 1981): 631-640.

Saunders, R.J., J.J. Warford and B. Wellenius. Telecommunications and Economic Development (1983).

Williamson, Oliver E. The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting. New York: Free Press, 1985.

Williamson, Oliver E. "Transactions Cost Economics: the Governance of Contractual Relations." Journal of Law and Economics 23, 2 (October 1979): 233-267.

- SECTION 3 -

INSTITUTE FOR LIBERTY AND DEMOCRACY: ACTION PROGRAMS

LETTER TO CADE

Lima, November 25, 1987

Fellow Entrepreneurs:

CADE meets at a particularly critical moment: it is increasingly difficult to conduct business in Peru; prospects for progress are now limited for both the rich and the poor, and expectations end up in frustration in the midst of an atmosphere of insecurity and uncertainty caused by the repeated infringement of basic economic rights.

This reality affects formal entrepreneurs as well as millions of informal businessmen: street vendors, shop owners, settlers, urban bus operators, small manufacturers, farmers, fishermen, and craftsmen.

Those who refuse to admit that private enterprise is an instrument of development, engage in perpetuating the notion that the poor cannot be businessmen. Reality, however, shows that most poor and informal Peruvians are indeed businessmen, who creatively operate private enterprises. While the State's arbitrary measures affect them differently, their economic rights are identical to those that you see endangered today.

No effective defense of these co: n economic rights can be successful unless formal entrepreneurs identify with the ideals of the street businessman, so all can identify with the same cause.

As long as the economic rights of all of Peru's business community are not respected, abuses in the name of "popular majorities" against a "few privileged ones" will continue.

In this context, the Institute for Liberty and Democracy cannot fail to acknowledge the historical impact that entrepreneurs, at the CADE '87 meeting, can exercise in behalf of these fundamental economic rights.

Sincerely,

Institute for Liberty and Democracy

Encl: Declaration of Economic Rights

Institute for Liberty and Democracy
Benavides 881 - P.O. Box 18-1420 - Lima - Peru
Telephone Nos. 470916 - 469128

ECONOMIC RIGHTS

1. The right to progress within free excercise of the economic activity.
2. The right to property and ownership.
3. The right to preserve the purchasing power of income and savings.
4. The right to contract.
5. The right to the issuance of reasonable and justified regulations.
6. The right to access to government information.
7. The right to participate in the governmental decision-making process.
8. The right to not have to make unlawful payments.
9. The right to legal protection.
10. The right to the independent administration of justice.
11. The right to demand rationality from state-sponsored ventures.
12. The right to not be affected by monopolistic governmental practices.

THE CITIZENS, INDIVIDUALLY OR ASSOCIATED IN BUSINESSES, ASSOCIATIONS, NEIGHBORHOOD ORGANIZATIONS AND TRADE UNIONS DEMAND THAT THE GOVERNMENT RESPECT THEIR ECONOMIC RIGHTS:

1. The right to seek wellbeing and progress in the exercise of their economic activity, free from arbitrary, costly and unnecessary procedures.

Example: formal companies must comply with complex formalities in order to make new investments, alter prices, import inputs and equipment, export their products; convert lines of credit; likewise, individuals are not allowed to conduct export activities.

Example: informal entrepreneurs suffer when licensing procedures for small businesses take up to 289 days to complete; when private initiative is restricted by urban transportation routing assignments; when cabbies' work is restricted through the unrealistic requirement of the use of taxi-meters; when street vending is irrationally regulated, as set forth in Ordinance 002.

2. The right to retain property and ownership and to not be subject to their arbitrary deprivation by the State nor to be denied legitimate property expectations.

Example: the State expropriates banks, financial companies and insurance companies from formal businessmen without proving the need of such actions nor the public interest served by them; it forces the transfer, for political reasons, of corporation stocks, as in the case of the intervention of Leche Gloria dairy products; it freezes bank certificates in foreign exchange; it does not provide the mechanisms which guarantee the intangibility and recuperation of private assets.

Example: in the case of informal entrepreneurs, the State denies them possession of vacant state lots, by requiring 207 different steps that must be met at 54 public bureaus; it withholds legal recognition of the young towns formed after April 14, 1986; it does not issue standards to prevent dwellers of settlements from the invasion of squatters on their lands, nor to protect their acquired rights resulting from the subdivision of their lots; it arbitrarily cancels urban transportation routing concessions, disregarding the acquired rights of thousands of bus operators; it orders massive and ruthless seizures of merchandise from street vendors.

3. The right to not see the purchasing power of their money and savings impaired by the State.

Example: Both formal and informal businessmen are affected by the handling of public finances; inflationary financing of the fiscal deficit, which has increased the volume of money five-fold in two years; State confiscation of more than 800 million dollars through the inflationary process, the damage of which exceeds 350 million dollars for informals; confiscation of nearly 1.6 billion dollars owned by eight million savings account holders, by the institution of interest rates below inflation rates, at a cost of more than 270 million to informals; the impossibility of obtaining reasonable yields from savings, prohibiting foreign currency deposits or any other profitable alternative in real terms.

4. The right to freely contract and to require the Government to respect and enforce contracts to which it is a party, and those between individuals.

Example: the Government, in an action which affects formal businessmen, has regulated rents and postponed indefinitely property rental agreements; also, in a breach of its own contracts, the Government decided unilaterally to substitute devaluated bonds for cash payments agreed upon with contractors and exporters.

Example: informal bus operator committees must incorporate, denying them the right to adopt business structures more suitable to their needs; moreover, by disregarding an agreement with them, the Government has failed to recognize their right to import new units, thus benefitting ENATRU PERU.

5. The right to governmental provision of a clear legal structure to facilitate economic activity through reasonable standards, free from unnecessary costs nor issued without due evaluation and justification.

Example: formal entrepreneurs suffer from exceptional labor policies which, although favorable, are adopted without the requisite steps to ensure legality, resulting in uncertainty; moreover, compliance with complex procedures required of small business, means that its administrative staff must waste 60% of their time to comply with these formalities.

Example: vehicles owned by informal bus operators are harassed and at times seized during "peak hours", when they are most in demand; settlement dwellers are subjected to absurd requirements --such as Law #23853-- which, under eviction threat, forbid temporary absences or accommodation of relatives or friends.

6. The right to access to government-controlled information and to keep abreast of government actions or projects.

Example: the State refuses to inform formal businessmen on the allocation of funds borrowed by the Government from the IPSS; nor the unexplained delay in publication of the very costly contract between ICE and the Société Générale de Surveillance S.A. (SGS) to oversee foreign trade.

Example: informals cannot get information on the funds for electrification and sewage works in marginal areas obtained through forceful application of a 10% surcharge on electricity and water supply bills; nor on funds for the Highway Transportation Fund accruing from the 6% tax included in the price of gasoline; nor on methods employed in determining public utility service rates.

Often, both formals and informals are not aware of the existence or contents of policy decisions that are not published in the official gazette; last year, 89 Executive Orders in the Economy and Finance Sector remained unpublished.

7. The right to be heard by the Government in consultation proceedings on the adoption of standards and decisions affecting economic and social interests.

Example: the procedure for the issuance of standards does not contemplate mechanisms for consultation with those potentially affected, whether formal or informal: The Executive Branch dictates 98% of state decisions. The sudden intervention of the banking community, eviction of street vendors or settlement residents are the product of policies adopted without consultation, that do not consider socially and economically beneficial alternatives, rendering them vulnerable by a lack of consensus as to their implementation.

8. The right to expect the State to provide an institutional framework so that payment of bribes or other unlawful expenses required by civil servants is eliminated.

Example: for formals, restrictions on foreign trade are a source of bribes imposed by license grantors and customs officials; obsolete systems and the deficiencies of the Public Registers result in procedures which may take years unless a "bonus for overtime" is paid.

For example: in the case of informals, private sector bus owners are harassed by officials who use the countless regulations to apply the law more strictly, unless a bribe is paid; street vendors, bus owners, informal small entrepreneurs, and

settlement dwellers --due to the need to operate outside the legal framework-- are constantly victimized by bribe demands simply to avoid severe penalties or the total loss of their businesses or assets.

9. The right to require the government to develop and implement a legal system for the punishment and discouragement of felonies; acts of misconduct; and negligence regarding persons and property.

Example: while formals seek their own protection through insurance contracts, informals are forced to associate in committees or in self-defense organizations. Neither formals nor informals are compensated for losses incurred by actions or omissions of third parties, as is plain to see in the case of traffic accidents.

10. The right to have the judicial system resolve disputes by a low-cost, independent, honest, speedy, clear, and predictable system.

Example: the recent state takeover of the financial system reminds one of the interferences by the Executive Branch in judicial resolutions, which support the legitimate expectations of formal owners affected by clearly unconstitutional measures.

Example: in the case of informals, the Judicial Branch continues to blindly apply stiff standards, even though informals have generated creative systems for an alternative administration of justice that should be integrated into the state justice system.

11. The right to not have the State squander their monies in government-sponsored investments that do not demonstrate their promotion of social interests and that favor the private, bureaucratic, r political interests of appointed officials and government authorities.

Example: both the formal and the informal are equally affected: by the "investment" of 10 million dollars in the construction of an "electrical train" that runs for 14 city blocks, a work initiated without any surveys or secured financing, designed even though it was known that thousands of informal private bus owners would be affected; by the financing of inefficient public enterprises, that annually lose more than 500 million dollars; and, more recently, by the expropriation of the financial system.

12. The right to demand that the government stop maintaining monopolistic enterprises or adopting restrictive trade policies.

Example: the Government uses monopolistic policies in the case of inputs and basic services, at high cost and poor quality, causing a rise in production costs for formal and informal businesses, thus hurting the consumer.

Example: SIDERPERU reaps benefits, without benefitting Peru, from the steel supply monopoly; Paramonga benefits from the oligopolistic marketing of paper; MINPECO has regained a monopolistic right in the marketing of minerals at the expense of medium- and small-size mining concerns, which receive too late, too little, or never their export earnings; CPT and ENTEL-PERU monopolize the telephone service, obliging users to wait years to obtain a telephone line, only to receive poor and costly service later; lastly, the Government controls 80% of overland freight as a result of the operation of its monopolistic enterprises.

Without respect for citizen's economic rights, investment, work, and personal effort will greatly diminish. As long as formal and informal entrepreneurs are able to identify themselves as the majority, and it is understood that protection of their economic rights means wealth for all, the political powers must respect them. If private enterprise is identified only with small formally-organized groups, the government will continue to affect the economic rights of some, alleging representation of many others. Will CADE '87 provide the forum to ponder this task, one which must not be delayed?

UN CASO CLARISIMO DE MERCANTILISMO*

Entre setiembre de 1988 y enero de este año, los transportistas obtuvieron del gobierno un conjunto de medidas para liberalizar la economía del transporte, entre ellas la libre importación de neumáticos y la reducción de aranceles e impuestos.

Goodyear del Perú ha interpuesto recurso de amparo buscando anular esas medidas.

*** MERCANTILISMO: Sistema económico y político que se bosquejó hacia el siglo pasado en Occidente, antes del establecimiento de la economía social de mercado, y permitía a unas pocas empresas aprovechar el poder normativo del Estado para vivir a costa de los otros. Dicho sistema aún subsiste en muchos países subdesarrollados, como el nuestro, y es causa principal de su atraso.**

EL COSTO DEL PRIVILEGIO

De tener éxito esta acción, otra que ha sido efectuando Goodyear del Perú buscando mantener los privilegios que la sigan protegiendo de la competencia, sucedería lo siguiente:

1) Todos los peruanos gastaríamos 101 millones de dólares, es decir 132 mil millones de intis, por concepto de la diferencia de precio en el costo de la llanta nacional frente al neumático de importación.

2) Se mantendría el mercado cautivo que quieren los accionistas de la Goodyear del Perú, los cuales, por supuesto, se escudan en la defensa de los puestos de trabajo que dependen de esa industria en el país. Si se acepta ese argumento, hay que tener en cuenta que los US$ 101 millones subvencionan a escasamente 1,258 trabajadores, que constituyen la fuerza laboral de la industria de llantas en el país, versus los intereses de 300 mil transportistas informales, de 196 mil propietarios de automóviles particulares y los millones de usuarios del transporte público en el Perú.

3) Lo anterior significa que mantener el privilegio de Goodyear del Perú representa subsidiar a cada uno de los 1,258 puestos de trabajo con 80,408 dólares anuales, o sea 101 millones de intis. Si se quiere mantener puestos de trabajo, mayor sentido tendría recaudar ese dinero y pagar remuneraciones a los 1,258 trabajadores en su casa. En cifras, esto significaría alrededor de 5 millones de dólares, lo que permitiría un remanente de US$ 96 millones, que podrían usarse en la creación de hasta 434 mil puestos de trabajo similares a los del PAIT en todo el país.

En resumen, el accionar de Goodyear del Perú va en contra no solamente de los intereses de las mayorías nacionales, sino también de las condiciones básicas que requiere el funcionamiento de una economía social de mercado en el país.

LO QUE HAREMOS

Por ello, la FECHOP y el ILD han decidido movilizar sus recursos para combatir el mercantilismo y abrir aquellas medidas del gobierno que propician el desarrollo de la economía social de mercado. En tal virtud, la FECHOP y el ILD iniciarán la inmediata y sucesiva adopción de medidas en los ámbitos internacional y nacional para impedir que el mercantilismo logre sus objetivos, esfuerzo que será redoblado conforme se produzcan los acontecimientos.

Acciones en el ambito internacional

1) Estamos enviando una carta al señor James E. Baker III, Secretario de Estado de la Administración Bush, pidiéndole tome conocimiento del asunto para que se apliquen las políticas y recomendaciones que él formuló cuando era Secretario del Tesoro y que incluyó en el conocido Plan Baker. El año en Seúl y en París, que su plan se basa en la necesidad de que los países en desarrollo hagan los ajustes estructurales necesarios para ser competitivos, sin esperar las negociaciones multilaterales. También en Indianápolis, hablando de "El Otro Sendero", reconoció explícitamente a los informales peruanos cuando saludó "su gesta espontánea y creativa en contra de las políticas erradas". El señor Baker comprobará, así, que en muchos casos el fracaso de las políticas de ajuste estructural no deriva de las posiciones de sus clases populares, sino de la actitud asumida por ejecutivos de su propio país que se han acostumbrado a vivir de las distorsiones de nuestro sistema mercantilista.

2) También estamos enviando una carta al señor R. E. Mercer, Presidente del Directorio y máximo ejecutivo de Goodyear Tire and Rubber Company, Estados Unidos, informándole de esta grave situación. En la misiva pedimos al señor Mercer, conforme lo dijo en el Business Forum de la Universidad de Miami el octubre de 1987, en su alegato por la competencia y contra los artificios legales usados para ganar el mercado, y donde recordaba que Goodyear concentra "su energía en una efectiva y total competitividad", que aplique a la letra, en el Perú, dicha política y que la conducta de su subsidiaria no constituya, en modo alguno, excepción a la regla.

Acciones a nivel nacional

3) Invitar al Presidente de Goodyear del Perú para que, en lugar de proteger sus utilidades yendo en contra de la liberalización, busque inmediatamente fórmulas constructivas que sirvan para proponer al gobierno la reestructuración de aquella sobreregulación que le crea excesivos costos de producción y lo obliga, a su vez, a elevar precios del producto final. El camino no es preservar costosos mercantilismos, sino cambiar las estructuras y el ILD estará dispuesto a ayudarlo.

4) La FECHOP responderá, en el ámbito judicial, el recurso de amparo de la Goodyear del Perú contando, como lo ha hecho a lo largo del proceso de liberalización, con el respaldo y la asesoría del ILD.

5) Convocar a una conferencia de prensa con asistencia de todos los medios informativos locales y las agencias de noticias acreditadas en el Perú, para ampliar los detalles de este aviso.

Lima, 10 de marzo de 1989

CONFERENCIA DE PRENSA
Día
viernes 10 de marzo de 1989
Hora
12 mediodía
Lugar
Instituto Libertad y Democracia
Avenida Benavides 881 - Miraflores
Tel. 470916

Federación de Choferes del Perú

Instituto Libertad y Democracia ILD

El Comercio Lima, Friday, March 10, 1989

ANNOUNCEMENT

A CLEAR-CUT CASE OF MERCANTILISM*

Between September, 1988 and January of this year, transportation workers obtained from the government a package of measures to liberalize the economy of the transportation sector, including the duty-free importation of tires and the reduction of taxes and tariffs.

Goodyear of Perú has filed an appeal, seeking to have the measures rescinded.

THE COST OF THE PRIVILEGE

If this action is successful, along with others which Goodyear of Perú has been taking in an attempt to conserve the privileges which continue to protect it from competition, the following will take place:

1) As a whole, Peruvians will spend 101 million dollars, i.e., 122,000,000,000 Intis, which represents the price differential between domestically produced tires and imported tires.

2) The captive market which Goodyear of Perú shareholders seek to maintain will, in effect, be maintained; these shareholders, of course, are acting in the interest of defending the jobs which depend on the country's transportation industry. If that argument is accepted, it must be borne in mind that the US$101 million will effectively subsidize scarcely more than 1,258 workers, which make up the labor force of the country's tire industry, in contrast to the interests of 300,000 informal transportation workers, 390,000 private automobile owners and the millions of users of public transportation in Perú.

3) The foregoing means that maintaining Goodyear of Perú's privileges represents a subsidy to each of the 1,258 employees of $0.490 annually, or 105 million Intis. If what is sought is to keep jobs, it would make more sense to collect that amount of money and pay compensation to those workers in their homes. In numerical terms, this would mean about $5 million, leaving US$96 million which could be used to create as many as 434,000 jobs, similar to those at PAIT, throughout the country.

In short, this action by Goodyear of Perú goes not only against the interests of the majority of Peruvians, but also against the basic conditions required for the functioning of a social market oriented economy in the country.

WHAT WE WILL DO

For this reason, FECHOP and the ILD have decided to mobilize their resources to combat mercantilism and support those government measures which protect the development of a social market oriented economy. Toward this end, FECHOP and the ILD announce the immediate and continuous adoption of measures, at both the national and international levels, to prevent mercantilism from achieving its objectives -- an effort which will be intensified as events occur.

Actions at the International Level

1) We are sending a letter to Mr. James E. Baker III, Secretary of State in the Bush Administration, requesting that he take cognizance of this matter, so that the policies and recommendations which he established while he was Secretary of the Treasury and which he included in the well-known Baker Plan be applied to this situation. Mr. Baker stated, in Seoul and Paris, that his plan is based on the need for developing countries to make the structural adjustments necessary in order to be competitive, without waiting for multilateral negotiations. In Indianapolis as well, while speaking of "The Other Path" ("El Otro Sendero"), he explicitly recognized the Peruvian informal sector when he praised "their spontaneous and creative effort against misdirected policies." Thus, Mr. Baker will be able to prove that in many cases the failure of policies of structural adjustment is not the result of the positions assumed by the popular classes, but rather of the attitudes of executives in his own country who have become accustomed to living off the distortions of our mercantilistic system.

2) We are also sending a letter to Mr. R.E. Mercer, President of the Board and Chief Operating Officer of Goodyear Tire and Rubber Company, in the United States, informing him of this grave situation. In the letter, we ask Mr. Mercer -- as he stated in the Business Forum at the University of Miami in October 1987, in his plea in favor of competition and against the legal artifices used to gain access to the market, and where he recalled that Goodyear focuses "its energy on an effective and total competitiveness" -- to apply that policy literally in Perú and to ensure that the conduct of its subsidiary in no way constitutes an exception to the rule.

Actions at the National Level

3) Suggest to the President of Goodyear of Perú that, instead of protecting his profits by opposing liberalization, he immediately seek constructive formulas which might serve to propose to the government the restructuring of the situation of overregulation that gives rise to excessive production costs and in turn obligates the firm to increase the prices of the finished product. The road to follow is not one of conserving costly mercantilisms but rather of changing structures, and the ILD is willing to help.

4) FECHOP will respond, in the legal arena, to the appeal filed by Goodyear of Perú with the support and advisory assistance of the ILD, as has been the case throughout the process of liberalization.

3) Call a press conference, with the attendance of all of the local news media as well as the news agencies accredited in Perú, to elaborate on the details of this announcement.

Lima, March 10, 1989

Press Conference

Date:
Friday, March 10, 1989
Time:
12:00 noon
Place:
Instituto Libertad y Democracia
Avenida Benavides 881 -- Miraflores
Telephone: 470916

Federation of Drivers of Perú

Instituto Libertad y Democracia

Cartoon Caption:

* MERCANTILISM: The economic and political system prevailing in the western world up until the last century, prior to the establishment of the social market oriented economy, and which permitted a small number of firms to take advantage of the normative power of the State to live at the expense of others. This system still persists in many underdeveloped countries, such as ours, and constitutes the principle cause of their backwardness.

Institute For Liberty and Democracy
(Instituto Libertad y Democracia)

Headquarters
Benavides 881
Casilla Postal 18-1420 - Lima - Peru
Tel.s: 011-5114-443509 469125
Fax: 011-5114-~~[illegible]~~ 475-604

Hernando de Soto
President

U.S. Office
655 15th Street, N.W. Suite 300
Washington, D.C. 20005
Tel. (202) 639-4067
Fax: (202) 347-1441

ILD UPDATE

The ILD is pleased to announce that on January 20, 1990, the Property Register of the Popular Mortgage Program was successfully launched in Lima. A copy of the newspaper ad which appeared in El Comercio as part of ILD's public awareness campaign is enclosed.

Also enclosed is the February 13 Wall Street Journal article "Property Rights: The Way Out for Coca Growers," by Hernando de Soto. The article is based on an ILD proposal written at the request of President Alan Garcia of Peru for the Cartagena Drug Summit.

For further information, call Ms. Christine Ternent, ILD - U.S. Office, (202) 639-4067.

EL PERU NO ES UN PAIS DE PROPIETARIOS

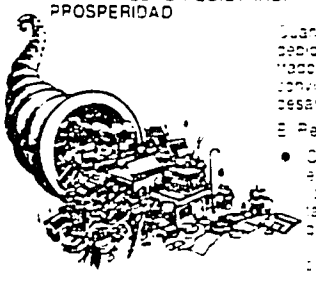
PERO LO SERA EN MENOS DE 5 AÑOS CON EL REGISTRO PREDIAL

Hoy la mayoría de las familias peruanas poseen viviendas y tierras que son sus bienes mas preciados. Solo en el área urbana, estos bienes equivalen a 16 500 millones de dolares, que es mas de lo que producimos todos los peruanos en 1989.

Pero resulta dramatico que el 4 % de las viviendas de los asentamientos humanos y el 10 % de las tierras rurales tengan un titulo de propiedad registrado.

Que estos bienes no esten titulados ni registrados es la razon mas importante por la cual los pobres no han podido salir de su miseria y que siga los conflictos de clases que engendran violencia al dividir al pais entre los que tienen propiedad y los que no la tienen.

LA PROPIEDAD REGISTRADA Y DIFUNDIDA CREA PROSPERIDAD



Cuando los inmuebles estan debidamente titulados y registrados, pueden su valor y se convierten en instrumento de desarrollo.

El Registro Predial permitira:

- Convertir el resultado del esfuerzo personal y familiar en capital activo, en tanto se puede vender, alquilar, prestar o utilizar con fines productivos con absoluta seguridad.
- Incentivar la inversion ya que aumenta nueve veces mas el valor del inmueble en un plazo de diez años.
- Utilizar el inmueble como garantia hipotecaria para acceder al credito. En los paises desarrollados la propiedad titulada y registrada constituye el principal elemento de garantia para el financiamiento de una empresa.
- Evitar que el propietario sea desalojado arbitrariamente o que su bien sea ocupado por terceros sin su consentimiento.
- Minimizar los juicios al eliminarse las dudas sobre la propiedad.

LA PROPIEDAD REGISTRADA Y DIFUNDIDA QUITA MOTIVOS A LA VIOLENCIA

Como la propiedad es el canal principal para el progreso economico y social, su falta de reconocimiento puede producir frustracion que desemboca en la violencia.

El Registro Predial permitira:

- Proteger a las mayorias de las formas mas primarias de explotacion y despojo por aquellos que pueden manipular la ley.
- Disminuir la dependencia y la subordinacion de estas frente a los pocos que tienen propiedad.
- Otorgar a todos un espacio de dignidad y de intimidad tan soberano e inalienable como el de los mas poderosos.
- Crear un interes concreto de las clases emergentes en un regimen de propiedad privada ya que ellos tambien pueden tenerla.
- Disminuir los antagonismos sociales existentes al extender las oportunidades de progreso que hoy se encuentran restringidos a unos pocos.
- Empezar a construir una economia social de mercado con efectiva participacion de la mayoria.

UN NUEVO REMEDIO PARA UNA VIEJA ENFERMEDAD

Luego de 4 años de estudios se ha creado el Registro Predial de Pueblos Jovenes y Urbanizaciones Populares (Registro Predial) que de alguna manera sustituye al Registro de la Propiedad Inmueble (Registro Inmobiliario). El Registro Predial se ha hecho a la medida de las posibilidades de la gente, teniendo a la puerta de la propiedad a todos los Asentamientos Humanos, a todos los Parceleros y a todas las Comunidades Campesinas del Peru.

AYER

Registro Inmobiliario

1. La inscripcion demanda en promedio 4 meses.
2. Registrar una vivienda cuesta 30 millones de inti.
3. Es de complicados documentos, muchos escrituras publicas y muchisimas gestiones.
4. Esta centralizado en la capital.
5. Utiliza libros diseñados hace cientos de años con informacion dispersa y de difícil acceso.
6. El registro no es responsable ante la comunidad publica.
7. Es de presentacion de documentos a veces a la propiedad.
8. Se basa en largas e improductivas descripciones de la propiedad.
9. La propiedad solo se puede probar a través de instrumentos publicos.

HOY

Registro Predial

1. La inscripcion demanda en promedio menos de un mes.
2. Registrar una vivienda cuesta en promedio 65 mil intis, esto es menos del 1%.
3. Es simplificado. Solo se requiere formularios impresos en los que basta la verificacion privada de abogados, arquitectos o ingenieros.
4. Es descentralizado. Se instalaran Registros Regionales a nivel nacional.
5. Empresa computadoras que garantizan la seguridad y rapidez del manejo de la información a nivel nacional.
6. Los pobladores y representantes elegidos por el pueblo forman parte del Directorio.
7. Solo exige pruebas de posesion o propiedad.
8. Se basa en la prueba concreta de las construcciones y sus cercos.
9. La propiedad se puede probar además con elementos de derecho consuetudinario que tienen vigencia social, tales como el testimonio de las organizaciones populares y de los vecinos, así como con documentos informales como los que acreditan el pago de los servicios de agua, luz y arbitrios.

EL 20 ARRANCAMOS

El 20 de enero, en Palacio de Gobierno a las 12 a.m., el Presidente de la Republica pondra en marcha el Registro Predial, que incorporara en 5 años a las mayorias nacionales (Asentamientos Humanos, Comunidades Campesinas, Parceleros, Cooperativas y todos los demas poseedores de tierras) al Sistema Legal.

TODOS PUEDEN PARTICIPAR

Todos los que quieran participar de los beneficios del nuevo registro pueden obtener informacion en:

— Instituto Libertad y Democracia
Avenida Benavides 861 Miraflores

REGISTRO PREDIAL: PAIS DE PROPIETARIOS

Convenio Gobierno - Instituto Libertad y Democracia (ILD)

TRANSLATION OF NEWSPAPER AD APPEARING IN EL COMERCIO 1/15/90

PERU IS NOT A COUNTRY OF PROPERTY OWNERS

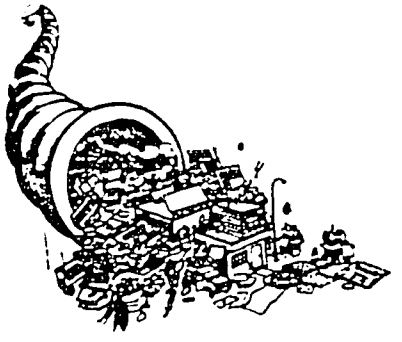
But it will be in less than five years with the inauguration of the Property Registry

Today, most Peruvian families possess homes and lands which constitute their most prized belongings. In the urban area alone these goods are equivalent in value to 16.5 billion dollars, which is more than all Peruvians produced in 1989.

But what is most dramatic is the fact that less than 4 per cent of the homes owners in the human settlements and less than 10 per cent of rural landholders have a registered title to their property.

The fact that these goods have neither been titled nor registered is the main reason why the poor have not been able to rise above their poverty and why we continue to be beset by class struggles, which beget violence by dividing the country between those who own property and those who do not.

PROPERTY WHICH IS REGISTERED AND BROADLY DISTRIBUTED CREATES PROSPERITY

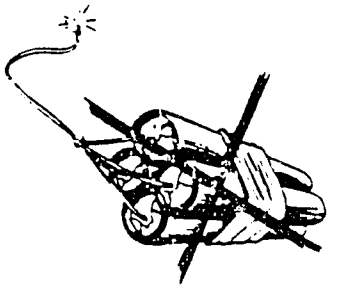


When real property is duly titled and registered, its value increases and it becomes an instrument of development.

The Property Registry will make it possible to:

- Convert the results of personal and family efforts into active capital which can be sold, leased, loaned or used for productive purposes with absolute safety.
- Encourage investment since the value of the real estate will increase nine-fold over a period of ten years.
- Use the real estate as mortgage guarantee in order to gain access to credit. In developed countries, property which is titled and registered constitutes the principal guarantee element for launching a new business.
- Prevent the property owner from being arbitrarily evicted or his property from being occupied by third parties without his consent.
- Minimize litigation by eliminating all doubts with regard to the property.

PROPERTY WHICH HAS BEEN REGISTERED AND BROADLY DISTRIBUTED ELIMINATES THE CAUSES OF VIOLENCE



As property is the principal conduit for social and economic progress, the failure to recognize property ownership can produce frustration which, in turn, leads to violence.

The Property Registry will make it possible to:

- Protect the majority of people from the most basic forms of exploitation and dispossession by those able to manipulate the Law.

- Decrease the dependence and subordination of the majority of people with respect to the few who do own property.

- Provide to all a personal space for freedom as sovereign and inalienable as that of the most powerful.

- Create a concrete interest on the part of the emerging classes in a regime of private property by virtue of the fact that they too are entitled to own property.

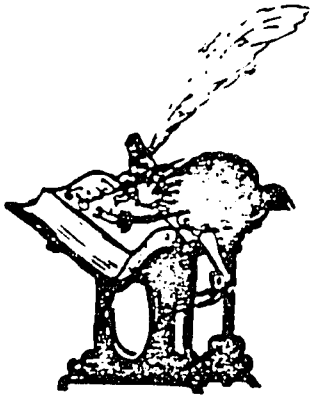
- Reduce the existing social antagonisms by extending the opportunities for progress which today are restricted to the few.

- Begin to build a social market economy with the effective participation of the majority.

(Box)

A NEW REMEDY FOR AN OLD DISEASE

After four years of study, the ILD has created the Property Registry of New Towns and Popular Housing Developments (Property Registry) which supersedes the obsolete Registry of Real Property (Real Estate Registry). The Property Registry has been custom designed in accordance with the realities of the country, thus opening the doors of property ownership to all Human Settlements, all Tenant Farmers, and all Campesino Communities in Peru.

YESTERDAY	TODAY
Real Estate Registry	Property Registry
	
- Registration requires an average of 48 months.	- Registration requires on average, less than one month.
- It takes 30 million intis to register one house.	- It takes an average of 65,000 intis to register one house.
- The process requires complicated documents, drafts, public deeds and a multitude of formalities.	- The process has been simplified. It requires only printed forms which simply require the personal verification of lawyers, architects or engineers.
- The Registry is centralized in the capital.	- The Registry is decentralized. Regional Registries will be established nationwide.

- Uses books designed hundreds of years ago to record information which is scattered and difficult to access.	- Uses computers which guarantee safety and speed in handling information on a nationwide basis.
- The Registry is not accountable to the general public.	- The residents and representatives elected by the people form a part of the Board of Directors.
- Requires the submission of documents not relevant to the property.	- Requires only the submission of proof of possession or ownership.
- Is based on vague and lengthy descriptions of the property.	- Is based on concrete proof of the buildings and their enclosures.
- Ownership can be proven solely by means of public documents.	- Ownership can be proven in addition through socially relevant elements of common law, such as the testimony of popular and neighborhood organizations and indicatory documents such as those providing proof of payment of taxes and water and light bills.

(box)

ON THE 20TH WE GET UNDER WAY

ON JANUARY 20, IN THE PRESIDENTIAL PALACE AT 12:00 NOON, THE PRESIDENT OF THE REPUBLIC WILL INAUGURATE THE PROPERTY REGISTRY, WHICH WILL INCORPORATE THE GENERAL CITIZENRY (HUMAN SETTLEMENTS, CAMPESINO COMMUNITIES, TENANT FARMERS, COOPERATIVES AND ALL OTHER LAND HOLDERS) INTO THE LEGAL SYSTEM.

ALL MAY PARTICIPATE

All those who wish to participate in the benefits of the new registry may obtain information from:

- Institute for Liberty and Democracy
  Avenida Benavides 881, Miraflores.

PROPERTY REGISTRY:
A COUNTRY OF PROPERTY OWNERS
Agreement between the Government
and the Institute for Liberty and Democracy (ILD)

EL PERU NO ES UN PAIS DE PROPIETARIOS

- EL 20 de enero, el Presidente de la República arranca con el **Registro Predial** elaborado por el Instituto Libertad y Democracia.

- Este sistema permitirá titular en menos de cinco años **a todos** los Asentamientos Humanos, **a todos** los parceleros, **a todas** las Comunidades Campesinas del Perú.

- Es un sistema totalmente **computarizado** que reduce el plazo promedio de titulación de **48 meses a menos de un mes** y el costo de hacerlo, **a menos del 1%**

- Dentro de cinco años, **todos seremos dueños del Perú y se habrán eliminado las causas principales de la pobreza y la violencia en nuestro país.**

REGISTRO PREDIAL: PAIS DE PROPIETARIOS

Convenio Gobierno-Instituto Libertad y Democracia (ILD)

TRANSLATION OF NEWSPAPER AD APPEARING IN EL COMERCIO 1/18/90

PERU IS NOT A COUNTRY OF PROPERTY OWNERS

- On January 20, the President of the Republic will inaugurate the Property Registry developed by the Institute for Liberty and Democracy.

- This system will allow titles of ownership to be issued to all Human Settlements, all tenant farmers, and all Campesino Communities in Peru in a period of less than five years.

- This SYSTEM is completely computerized and reduces the average period required for property titling from 48 months to less than one month and the cost of doing so to less than 1%.

- Within five years, we will all become owners of Peru and the principal causes of poverty and violence will have been eliminated from our country.

PROPERTY REGISTRY:
A COUNTRY OF PROPERTY OWNERS

Agreement between the Government
and the Institute for Liberty and Democracy (ILD)

THE WALL STREET JOURNAL

Property Rights: The Way Out for Coca Growers

By Hernando de Soto

LIMA – As President Bush prepares to travel to Colombia Thursday for the drug summit with leaders of the Andean nations, cocaine and Colombia are linked in American minds. But Peru supplies much of the raw material for the drug. The only means to control the supply of coca paste from Peru is through the eradication of the coca crop. But with more than 200,000 families with small farms dependent on its cultivation, working an area as strife torn as El Salvador but several times its size, it is crucial to the success of any eradication program that substitute crops be found.

Most of these farmers are poor and work very small parcels of land. When their coca plants are destroyed without compensation sufficient to offer them an alternative means of survival, they respond by simply starting anew elsewhere, expanding into ever more remote areas, looking to terrorist organizations for protection and, in the process, creating irreversible ecological damage to the Amazon jungles.

Peruvian Jungle

There are many alternative crops that are at least as profitable as coca, if not more so, like cacao, coffee and tropical nuts, and are more environmentally sound. To cultivate these alternatives, however, demands well defined property rights over the land, which are exactly what coca farmers in the Peruvian jungle do not have. These farmers are excluded, consequently, from all the economic arrangements that would make these crops viable alternatives, and that would bring them into the open market economy as legal, private entrepreneurs.

The alternative crops require investment, credit, larger scale production, and formal contracts with buyers. None of these can occur if the farmers are not legally linked to their land by registered, universally respected property rights:

- Investment will take place only if the farmer is confident of his ownership of the future returns from the investment. The Institute I head has shown that investment on urban land increases by as much as nine times in the 10 years after property rights have been legally recognized.
- The access of farmers to credit depends heavily on their ability to use their land as collateral. Untitled and with its ownership unclear, the land of those who cultivate coca is useless as collateral.
- Economies of scale require that these farmers join their resources through leasing, sales, cooperative efforts or other joint ventures. However, since none of them can prove ownership of their land, they do not have access to the contractual and legal instruments that make such moves possible or attractive.
- Finally, buyers of these alternative crops can deal only with large, stable producers or producer groups. There can be neither size nor stability without property rights.

Alternative crops require investment, credit, larger-scale production, and formal contracts. None can occur if the farmers aren't legally linked to their land.

The restrictions that confront the coca growers are the same as those faced by the great majority of economically active Peruvians – the "informals" – who have never had access to the legal institutions that would allow them to fully integrate into the market economy. The coca cultivators are worse off, however. They have been forced to deal with drug traffickers, who are willing to buy in the small lots that these farmers can produce, and who do not require formal contracts.

The informality of coca growers explains not only why they grow coca, but also why the authorities have such difficulties in enforcing the law. Authorities cannot easily locate untitled and unregistered farmers, nor work with them in crop-substitution programs, nor give them legal treatment different from that given to terrorists and drug traffickers. This situation legitimizes terrorist organizations, which frequently constitute the only local authority capable of handling civil disputes (concerning boundaries, for instance), or of protecting rural families from drug traffickers and arbitrary expulsion from their homes.

Titling and registering property, then, is a crucial ingredient of any plan to eradicate coca. The problem, however, is that the traditional titling and real-estate property registration system is obsolete. As in many other countries of Latin America, the property registry was copied from the Spanish registration system of the last century. So slow and costly is this system that it is estimated that less than 4% of the homes of Peru's poorer housing settlements and 10% of rural landholdings have the title they need to take advantage of formal markets.

Even in the relatively more developed cities, property titling and registration take an average of 48 months of dedicated effort, at a cost of $2,500, which is about twice the net annual income of the great majority of those cultivating coca. The complicated documents, deeds and notarized certificates required by the public registries are unknown to these farmers, who, for the most part, are illiterate. In addition, the registry system is centralized in the capital so that, in the face of any titling irregularities, interested parties must journey for several days to Lima. Finally, registry records are kept in large books with handwritten entries, a system that not only makes access inefficient but leaves the records vulnerable to alterations or loss, and so is unreliable as a legal instrument.

To replace the old registry and to title and register the informal sector of Peru, last month the Peruvian government inaugurated a totally new system, designed and implemented by the Institute. This registry could be extended easily to coca farmers, and could title most of them in less than three years, as one component of an enforceable crop substitution program to which they would have to adhere.

The system is specifically designed to title and register the informal possession of land quickly and reliably. Real estate can be inscribed into the computerized registry in less than one month at a cost of less than 1% of the old system's. This is because the new registry makes use of the common law that prevails in the area where the property is located. Coca growers know who owns what. Like their urban counterparts, they are organized in loose knit producer groups that keep informal registries. The software running the computers of the new registry has been designed to accept the information in these informal registries. The organizations of coca growers have publicly stated their willingness to participate in crop substitution programs that incorporate the new registry.

Once their property was inscribed in the new registry, the farmers would have access to the legal instruments that would make coca substitutes attractive to them. They would be able to associate themselves into cooperatives, or lease or sell their property, or use it as collateral for credit.

Would Displace Terrorists

Property titling and registration would pinpoint the location of each farmer within a precisely described area, facilitating supervision of the crop substitution agreement. It would permit the concentration of law enforcement efforts against the drug traffickers instead of against poor farmers. It will be easier to detect drug traffickers by monitoring the purchase and use of precursor chemicals and laboratory implements needed for the processing of coca leaves into paste. By defending property rights, civil authorities would be able to displace subversive terrorist groups that have been providing "government" services to farmers, gaining legitimacy for themselves.

Property rights are the key to coca eradication. Only these can induce farmers to give up coca and become legitimate entrepreneurs. Access to legal institutions will enable them to substitute lawful markets for criminal cartels.

Mr. de Soto is president of the Institute for Liberty and Democracy in Lima and author of "The Other Path" (Harper & Row, 1989). This article is based on a proposal prepared at the request of Alan Garcia, Peru's president, for the summit.

PART II
RESOURCE MATERIALS

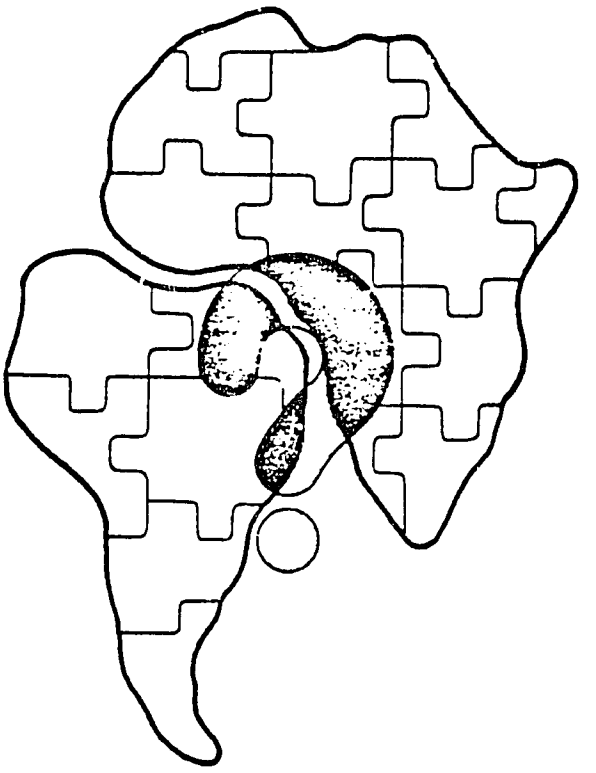
- SECTION 1 -

ILD TRAINING PROGRAMS: MODULE 1

TRAINING PROGRAM FOR AFRICAN RESEARCHERS
IN ECONOMIC ANALYSIS OF INFORMALITY
AND INSTITUTIONAL REFORM

MODULE ONE:

THE INSTITUTE FOR LIBERTY AND DEMOCRACY



November 27, 1989 – December 5, 1989

Sponsored By:

Institute for Liberty and Democracy
Lima, Peru

Agency for International Development
Bureau for Africa, Office of Technical Resources

MODULE ONE

THE INSTITUTE FOR LIBERTY AND DEMOCRACY

TABLE OF CONTENTS

I. INTRODUCTION 1

II. MISSION, OBJECTIVES AND STRATEGY OF THE ILD 2

A. MISSION 2

1. Achieve institutional reform in support of free markets and participatory government 2

2. Develop a model of institutional reform which may be applied throughout the developing world 2

B. OBJECTIVES 2

1. The Accountable State 2

a. Democratic Rulemaking 2

- Official Peruvian Rulemaking 3
- Non-government Rulemaking 3
- Rulemaking in Developed Countries 3

b. International Contracting and Financing of Public Investment Projects 3

2. The Enfranchising State 3

a. Administrative Simplification 3

b. Property Rights 3

c. Capital Markets 4

C. STRATEGY 4

1. Empirical Observation 4

2. Identification of Institutional Obstacles and Development of Reform Programs 4

3. Advocacy 4

4. National and International Dissemination 5

III. HISTORY AND ACCOMPLISHMENTS OF THE ILD 5

A. PERUVIAN SOCIAL AND ECONOMIC SETTING 5

1. Migration 6

2. Peruvian Economy 6

B. THE ILD: BEGINNINGS - 1980-1984 7

C. THE ILD: GROWTH - 1985-1990 8

D. MAJOR ACCOMPLISHMENTS 8

IV. ORGANIZATION AND WORK METHODOLOGY 10

A. ORGANIZATION 10

1. Research Division 10

2. Promotion and Dissemination Division 14

3. Finance and Administrative Division 15

B. OUTSIDE CONSULTANTS 15

V. LESSONS LEARNED 15

GLOSSARY 17

REFERENCES 18

NOTES 19

MODULE ONE

THE INSTITUTE FOR LIBERTY AND DEMOCRACY

I. INTRODUCTION

The Institute for Liberty and Democracy (ILD), a research and advocacy institute located in Lima, Peru, was founded in 1980 by Hernando de Soto to study the impact of legal institutions on economic development. The ILD's work was based initially on intensive research of the Peruvian informal sector, which has been forced outside of these legal institutions. Since its creation, the ILD has grown from a staff of two to its current staff of 35 professionals and 15 support personnel. Major research programs have been undertaken which have resulted in innovative institutional reform proposals, several of which have been made into law. The ILD has attracted considerable international attention among governments, institutions and political and social movements throughout the world, notably through the publication of the results of its initial research on the informal sector in Peru, in the best-selling *El Otro Sendero (The Other Path)*, which is now available in Latin America, the United States, Canada, Great Britain and Sweden.

Hernando de Soto notes in the preface to the U.S. paperback edition of *The Other Path*:

> " ... the best explanation for the book's success is that the story it tells parallels the experience of many other countries ... *The Other Path* seems to describe a useful paradigm for analyzing what has been occurring in many countries throughout the Third World.
>
> This paradigm unifies concern for the poor and the concerns of the poor, with the creation of a modern democracy and market economy. At the same time it clears an area of common ground where Left and Right can meet. It pushes those on the Right to realize that the free market is not enough, that modern political and judicial institutions must accompany liberalization if economic growth is to take place, if it is to be sustained, and if it is to be accompanied by social justice. As full participants, the poor will not only be the beneficiaries of economic growth, receiving the drops as they trickle down, but the engines of growth. To the Left, the paradigm has the reverse message. Capitalism is not incompatible with the elimination of poverty; it is rather the poverty of legal institutions that conspires to create the disparities that preoccupy the Left."

The **purpose** of this module is to describe the mission, objectives and strategy of the ILD, as well as its history, organization and work methodology. Upon completion of this module, participants should have a full understanding of how the ILD has evolved over time, what its major areas of activities are and how it goes about achieving its objectives. This understanding should prepare participants for planning the creation or expansion of programs of research and advocacy to enhance economic development through institutional reform in their own countries.

101

II. MISSION, OBJECTIVES AND STRATEGY OF THE ILD

A. MISSION

The mission of the ILD, simply put, is twofold:

- To achieve institutional reform in Peru which will ensure the peaceful and deliberate replacement of the existing mercantilistic system with modern, democratic and market-oriented structures;

- Through its work in the "laboratory" of Peru, to develop a model of institutional reform which may be applied in other developing countries in order to promote the evolution of modern market economies and participatory democracies.

B. OBJECTIVES

Based on its empirical studies in Peru, the ILD has emphasized that underdevelopment has to be seen in the context of **institutions**. It was, in fact, the symptoms of the institutional inadequacies in the governments of developing countries that initially attracted the ILD's attention, most notably the growth of a large, vibrant informal sector, operating outside of government control. Through its nearly ten years of study of the Peruvian reality and the observation and comparative study of the experiences of other countries, the ILD has a broad understanding of how institutions act and what changes are required to promote economic development.

The ILD's master plan for institutional reform, which it calls its Global Program, establishes two specific objectives: to achieve reforms which will result in the **Accountable State**, in which rulemaking takes into account the opinion of experts and those persons affected by such rules; and to achieve reforms which will lead to the **Enfranchising State**, in which access to economic activity is open to all rather than restricted to the few.

The ILD's work is guided and organized according to these two principle objectives for reform. (Each of the institutional reform programs summarized below is discussed in more detail in Module Three, Institutional Reform).

1. The Accountable State

To achieve the accountable state, the ILD is pursuing institutional reforms in the following areas:

a. Democratic Rulemaking

In Peru, citizens do not participate in any meaningful way in the production of law. Peruvian democracy functions only for the purpose of presidential, parliamentary and municipal elections. Once elected, government officials do not heed the public's opinion, nor do they seek to inform citizens of their actions. The institutional framework in Peru does not permit the elimination of rules and regulations which hamper economic activity. Rules are made to benefit the few at the expense of the majority. This has resulted in a lack of confidence in the state, which has discouraged investment and impedes development.

107

The ILD has set as a priority objective the achievement of reforms to ensure a democratic process of rulemaking in Peru. The ILD is conducting in-depth studies in three areas to determine the exact nature of the inefficiencies in the Peruvian rulemaking system and to establish realistic reform proposals. Those three areas are:

- official Peruvian rulemaking
- non-government rulemaking in Peru
- rulemaking in developed countries

The ILD has been charged by the President of the Republic to propose to the Executive and subsequently to Congress a master plan to create a democratic rulemaking process that ensures citizens' participation and feedback.

b. International Contracting and Financing of Public Investment Projects

Peru lacks the institutional capacity to contract on a competitive basis for public works projects financed by the state. As a result, public investment is negatively affected by overpricing in the execution of public works projects, oversizing of projects and inappropriate imported technology. The impact on the country's economy is reflected in the $15 billion foreign debt of the public sector of which fully $10.5 billion corresponds to loans for public investment projects, most of which were contracted for through "tied credit". The ILD estimates that the foreign debt for public investment projects should have been no higher than $6 billion, had adequate bidding and contracting controls been in place.

The ILD has set as a key objective the definition and design of a new institutional framework for the Peruvian public sector to enable it to adequately bid and contract for public works projects.

2. The Enfranchising State

To achieve the enfranchising state, the ILD is concentrating on reforms in the following areas:

a. Administrative Simplification

The ILD has noted the many complexities of attempting to deal with the state and is pursuing an ambitious program of administrative reform to simplify relations between the state and its citizens and to deregulate and decentralize the decision making process. In fact, Administrative Simplification is only the first step towards overall institutional reform of the state.

b. Property Rights

In Peru, secure property rights are not guaranteed. This breeds a general environment of uncertainty which stymies investment and development. Capital and brain drain from Peru to developed nations where property rights are secure is the solution for those who are able. Those who remain in Peru are forced to "pay off" officials who in one way or

103

another threaten their property rights. In the case of the poorest citizens, the creation of grass roots informal organizations is their only means of defense for their fragile rights.

The ILD has set as a priority objective institutional reforms which will give every citizen secure property rights.

c. Capital Markets

Credit allows producers to maximize income derived from their activity without being limited to the availability of personal resources. In Peru, significant sectors of Peruvian society have been excluded from formal financial institutions, particularly those who have little or nothing to offer as collateral due to the small scale of their enterprise. The lack of secure property rights seriously compounds the problem. Those excluded have recourse only to self-financing, informal credit markets or special government or donor programs with the high costs that the latter entail.

The ILD has set as an objective the achievement of institutional reforms which will render formal capital markets in Peru efficient and accessible to those who have been deprived of access. The objective of improved property rights will support this initiative by opening the door to mortgage credit for home owners who never benefitted previously from secure property rights.

C. STRATEGY

The ILD's strategy is a cyclical process involving four steps: (1) empirical observation, (2) institutional analysis and reform proposals, (3) advocacy, and (4) national and international dissemination. To elaborate:

1. Empirical Observation

This step involves the direct observation of day-to-day social, economic and institutional phenomena in Peru to determine constraints on economic growth or impediments to the process of participatory democracy.

2. Identification of Institutional Obstacles and Development of Reform Proposals

This step involves the identification of the laws and institutions which are responsible for the constraints on economic growth or impediments to participatory democracy, followed by an analysis of how these laws were generated. Reform proposals are then drafted to improve the institutio that affect the economic activity and the rulemaking process in general.

3. Advocacy

This step involves four activities: first, transmitting the message concerning the need for institutional reform using language and a presentation adapted to the target audience. Second, determination of the applicability of and the degree of support for the proposed reform, through public hearings and media coverage. Third, provision of resources and support to carry out the reform (from interest groups, individual researchers and

consultants, the general public, donor agencies and the government itself). Fourth, monitoring and receiving feedback from those affected that can be used for further investigation and improvements.

This part of the overall strategy is accomplished through a wide network of national press and media contacts, liaison with informal sector associations and presentations to local interest groups.

4. National and International Dissemination

This step involves the diffusion of information concerning the ILD's thesis of institutional reform and its achievements in the national and international press and at national and international conferences and events. The ILD is also committed to training international researchers and public sector decision-makers at seminars and workshops in Lima and to providing follow-on technical consultations to individuals or groups who pursue the creation or expansion of research programs in support of institutional reform. Dissemination of this information provides additional feedback on the validity of the ILD's programs in other parts of the developing world, as well as information on programs which have been effective elsewhere in remedying institutional or legal constraints to economic growth.

III. HISTORY AND ACCOMPLISHMENTS OF THE ILD

A. PERUVIAN SOCIAL AND ECONOMIC SETTING

In *The Other Path*, the changes in Peruvian society since the Second World War are identified as critical factors in the growth of informality and the public disenchantment with legal institutions. A key consideration is the fact that in the past forty years, **indigenous migration has quintupled the urban population** in Peru.

Cities have changed from small, familiar places to impersonal, densely populated metropolises with new, unfamiliar neighborhoods. The progressive intrusion of violence and crime into daily life has been coupled with a multiplication of misery. In general terms, the real income of Peruvians has fallen persistently over the past fifteen years, with a dramatic fall in 1989. Real income in 1989 is currently at the same level it was thirty years ago.

Well-defined attitudes have emerged with respect to the state. The bureaucracy has lost its social standing. Citizens have accepted bribery as a way of getting things accomplished and have learned to negotiate with the state for all sorts of privileges, resulting in a growing politicization as small interest groups fight each other for advantages.

Centralism, which has been traditional in Peruvian society, has shown itself incapable of responding to the many needs of a country in transition. The inefficiency of the courts has given rise to increased disillusionment and loss of confidence in the mechanisms established to ensure respect for the law. A growing dissatisfaction with the *status quo* has brought about a decline in the social relevance of the state. Terrorism, in the form of guerilla attacks by Peru's violent Maoist group, the Sendero Luminoso, or the "Shining Path," has emerged as a violent alternative to the current situation.

105

All of these changes were initiated when the residents of previously self-sufficient rural agricultural communities began to move to the cities, completely reversing the long historic trend which had kept them isolated. It is in its cities that the future of Peru is now being written.

1. Migration

The self-reliant farming communities of Peru had been threatened by the agricultural crisis of 1940 to 1945. In addition, they were discriminated against under the unstable process of agrarian reform. Attracted by better wages and better education available in the cities, and assisted by the construction of new highways, these farmers began a mass migration.

The change was dramatic: while 65% of the Peruvian population lived in rural areas and 35% in urban areas in 1940, these percentages were reversed by 1981. The increase was considerably higher in Lima, as compared to other urban centers. During this same period, the population of Lima increased by 7.6 times.

However, upon arrival in the cities, the migrants faced a hostile world whose inhabitants wanted nothing to do with the peasants. The legal system erected impossible barriers to the participation of the migrants in legal social and economic activities, including access to housing, education and private enterprise. It was at this point, faced with such opposition, that the migrants became informals. The intent was not antisocial, but designed to achieve essentially legal objectives, such as building a house, providing a service, or developing a business. In fact, *The Other Path* concludes that "informal activities burgeon when the legal system imposes rules which exceed the socially acceptable legal framework - does not honor the expectations, choices and preferences of those whom it does not admit within its framework- and when the state does not have sufficient coercive authority."

As the informals have advanced, the Peruvian state has taken to retreating, considering each concession to be temporary, "until the crisis has passed," when in reality it constitutes nothing more than unwillingly adopting a strategy of permanent retreat and one which, little by little, undermines its social relevance.

2. The Peruvian Economy

The Peruvian economy is in serious difficulty. In 1989, Peru's gross domestic product (GDP) per capita is estimated to be $1,100, down seventy percent from its 1981 peak. There is widespread unemployment. The $15 billion owed by Peru to foreign creditors is equal to over 80% of the country's annual GDP. State ownership of much of the banking sector, along with interest rate ceilings, has resulted in credit rationing which favors large, capital intensive projects over smaller entrepreneurs who must rely on informal credit.

The economy had begun to slip seriously under President Belaunde (1980 - 1985), the civilian president elected immediately after a twelve-year period of military dictatorship. The economy continued its serious decline under the Garcia presidency.

Alan Garcia, elected president in 1985 with a sweeping majority, instituted major reforms upon assuming office. He introduced an austerity program that included foreign exchange controls to arrest capital flight from Peru, increases in gasoline prices and devaluations

10

of the Peruvian currency. To help Peruvian consumers and salaried employees, he initiated price controls on basic goods, cuts in interest rates, increases in the minimum wage and government employee salaries. His most dramatic step was to announce that he would limit Peru's annual debt service payments to 10% of annual exports.

Because of his actions, inflation rates remain extremely high (annual inflation in 1989 is estimated to be 3,000%), IMF lending has been halted due to Peru's refusal to respect the repayment schedule requested by the IMF and international commercial banks are hesitant to engage any further lending.

B. THE ILD: BEGINNINGS- 1980 - 1984

Hernando de Soto, president and co-founder of the ILD, returned to Peru in the late 1970s to enter private business, after 15 years in business in Europe and the United States. As a young man, de Soto had been intrigued by the question of Peru's poverty and underdevelopment. Upon his return, noticing the changes in Lima due to the influx of migrants, including the creation of pueblos jovenes, or shantytowns on the edges of Lima, and the thousands of ambulantes or street vendors, who lined Lima's roads, he began to examine the economic and social aspects which might be responsible for Peru's underdevelopment. Also, as Peru prepared for the presidential elections of January 1980, following the twelve-year hiatus of military dictatorship, de Soto felt the need to engage Peruvians in a public debate on democracy and market economics.

In November 1979, he organized a symposium in Lima on "Democracy and the Market Economy," to which he invited noted European intellectuals, including Frederich von Hayek (recipient of the 1974 Nobel prize for economics) and Jean-Francois Revel, to debate and discuss issues related to democracy and free markets with Peruvian presidential candidates and political leaders from all factions. Twenty informal street vendors, who de Soto introduced as "tomorrow's entrepreneurs" were also invited. De Soto had hoped to arouse interest in the street vendors and the informal sector in general, so that research would be undertaken on their role in the national economy. No one took up the task.

Faced with this lack of interest, and seeing a natural "market gap," de Soto decided to undertake the research himself. He created the Institute for Liberty and Democracy in 1980 and for two years, with the assistance of a secretary, he devoted his evenings and weekends to interviews and visits to slums and informal sector businesses and industries.

In late 1981 he organized a second symposium on "Development and Dependence," at which American economist Milton Friedman and former U.S. Attorney General Elliot Richardson spoke. De Soto charged a $400 entrance fee to the symposium, which brought in $100,000 for the Institute. With that sum, de Soto set up a separate office, hired a clerical staff and was able to call upon a group of consultants, including lawyers, anthropologists and economists. (It was not until 1984 that he gave up his own fulltime job.)

In 1982, he obtained his first grant: $35,000 from the U.S. Agency for International Development (A.I.D.), to support his research. This amount was increased to $150,000 in 1983.

The ILD's original staff included young economists, engineers and lawyers. The institute initially studied the commercial and housing aspects of the informal sector, and then pursued the informal transport sector, industry and finance. As results of its studies were published in journals and newspapers, several government and private groups began to fund the institute's broadening research activities. In 1984 the ILD received $400,000 in funds from four donors, the major part again from A.I.D., who suggested that de Soto consider publishing his research in a book.

C. THE ILD: GROWTH - 1985-1990

In 1985 de Soto began work on his book, detailing the results of his analysis of the informal housing, transport and trade sectors, as well as his observations on the extralegal norms practiced within informal organizations and the "mercantilism" practiced within Peru's formal sector.

The Institute sought and was able to obtain a considerable increase in donor funding, moving from $400,000 in 1984 to $855,000 in 1985, from a total of seven donors.

Also in 1985 the ILD began major institutional and policy reform initiatives that built on its economic research.

In April 1985, the Marxist mayor of Lima issued an ordinance intended to bring the street vendors into the formal sector, through the strict controls of prices, the creation of a Communist structure of "cells" and the requirement that the vendors wear uniforms. The ILD conducted an economic and historical analysis of the proposed ordinance (see Module Three, Cost/Benefit Analysis) and found that many of the proposed measures had been applied previously, to no avail. The ILD's economic analysis showed that the ordinance would be very costly to the vendors. To publicize its findings, the ILD published a full page ad in *El Comercio*, Lima's largest newspaper. Subsequently the leaders of 111 street vendor associations of a total of 120 associations representing the 90,000 vendors, endorsed the ILD's position in another ad in *El Comercio*. The ordinance was abandoned. This was the first major regulatory reform success of the Institute.

Other major successes followed, with a growing number of endorsements from informals and politicians alike. For example, some 300,000 informal transport operators sought the ILD's support to obtain lowering of import tariffs on automobiles and spare parts. More than 300,000 informals signed petitions in support of land titling and registry for their informals settlements, a measure that was also endorsed by every major political party. In 1987, the Administrative Simplification proposal was also endorsed unanimously by the multi-partisan, bicameral Legislative Committee of the Peruvian Congress.

D. MAJOR ACCOMPLISHMENTS

The major accomplishments of the ILD to date have been:

- seminal research on the scale and scope of the informal sector, social class analysis, impact of law on economic growth (barriers to business licensing, barriers to titling property, importance of property rights in investment, among others) and development of appropriate means and language to communicate these findings to those concerned

108.

- publication of findings on informal housing, trade and transport in several working papers and in the book *El Otro Sendero*, which has become the all-time best seller in Peru, a number one best seller in Spanish-speaking Latin America and among the top ten best sellers in the Washington, D.C. market in its English-language, hard back edition

- formation of an office of Public Defense within the ILD which transmitted the concerns of millions of citizens to government authorities and the media

- stimulation of over 3000 articles in the Peruvian and international press on the ILD's work, with a broad consensus of support across the political spectrum, from marxists to neo-conservatives, on the need for institutional change to reform the existing "mercantilist" state of the Peruvian, and even the Latin American, economies

- adoption in 1985 by President Fernando Belaunde of an ILD proposal for citizen participation in the rulemaking of the Executive Branch, through a process of cost-benefit analyses, public notices and feedback

- adoption of a major Administrative Simplification Reform program in October 1988, supported by all major political parties, on both the national and municipal level, and implementation of those reform measures in August 1989

- approval of the ILD's proposed titling act to register informal property, and of a system for accessing formal credit for such property holders through mortgage credit ("hipoteca popular") from commercial banks and credit insurance from insurance companies

- advice and counsel sought of the ILD on institutional reform from major Peruvian political parties, foreign donors, regional and international research institutes, including over 30 organizations in 14 Latin American countries and 15 organizations in Africa and Asia requesting training and technical assistance

- as an outgrowth of the ILD's studies on informal sector enterprise, the acceptance that private entrepreneurship does work in Latin America (and indeed throughout the developing world) and is a suitable form of economic organization for the poor, which should be buttressed by adequate legal institutions allowing true access to private enterprise for all

In 1989, faced with the growing demand for the "internationalization" of the ILD's methodology and precepts, the ILD sought and received a considerable increase in donor funding for its efforts in this direction. Access to this increased funding has enabled the ILD to move ahead more rapidly with its research activities and reform proposals (including certain implementation responsibilities) and to undertake an ambitious program of training and dissemination of its work to the international community.

IV. ORGANIZATION AND WORK METHODOLOGY

A. ORGANIZATION

The ILD is a non-profit, non-partisan research and advocacy institute which is run by a board of directors composed of four persons, including leading Peruvian lawyers and private businessmen. The Institute is managed on a day-to-day basis by its President, Hernando de Soto, and its General Manager, Luis Morales-Bayro. A Program Review Committee, composed of national and international experts in institutional reform, is being constituted to consult regularly with the ILD on its programs.

There are three functional divisions within the ILD organization (see **Figure 1** for the present organization chart): Research, Promotion and Dissemination, Finance and Administration.

1. Research Division

Research is the activity which drives all other ILD activities. The ILD's research findings have formed the basis of its success in Peru and have attracted the attention of politicians, business groups, academics, journalists and development experts in Latin America and around the world.

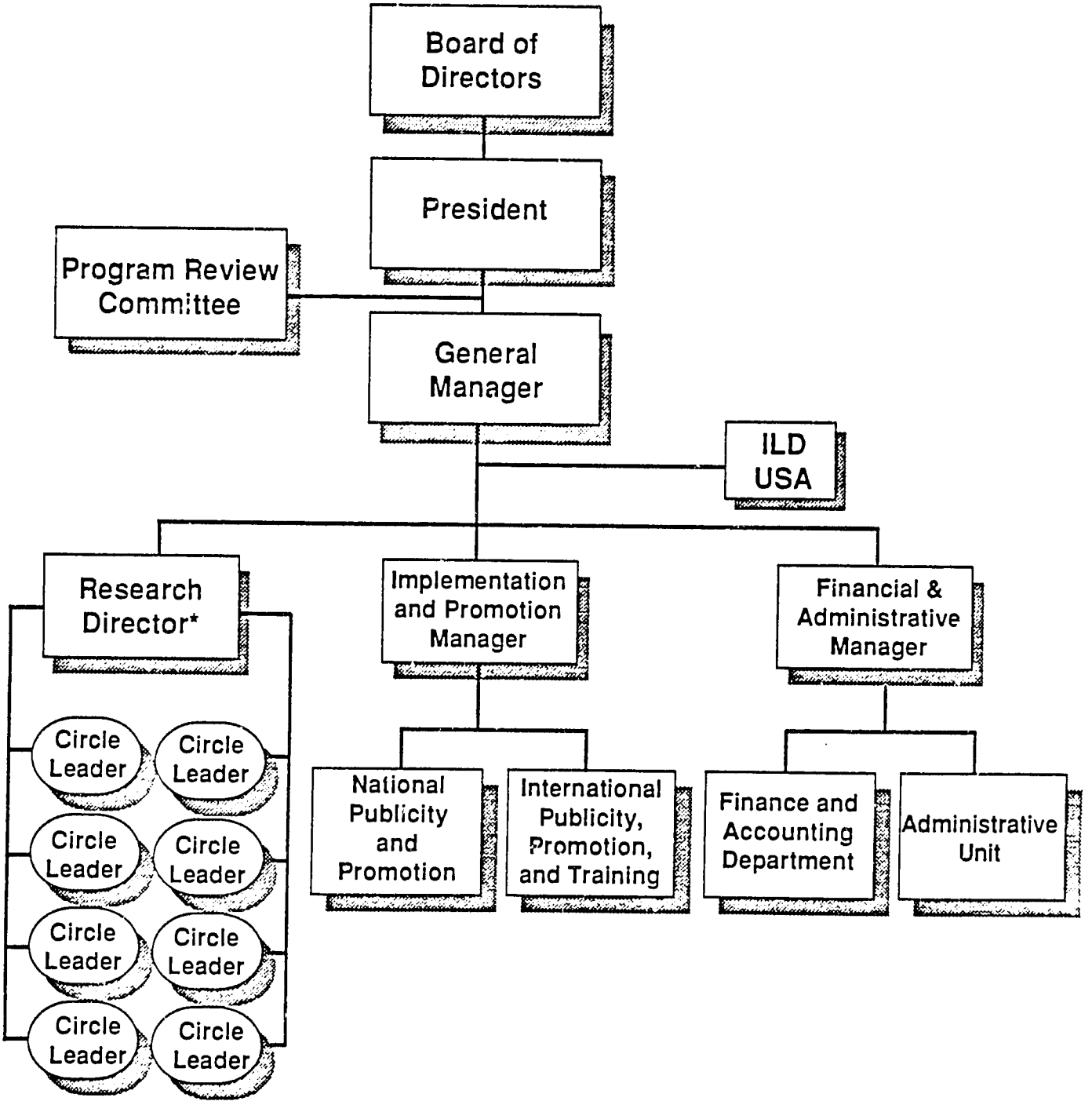
Much of the research performed by the ILD involves economic and legal analysis of field-collected data. This type of research is difficult because it requires data collection from primary sources, many of whom are found in the informal sector. Interviews with "informants" in both the informal and formal sectors go slowly but have begun to produce a reliable base of information on informality in Peru. This particular type of research has never been done before in such depth. (The ILD has been researching the informals and their economic activities for nearly ten years). In addition to the conclusions reached, the very methodology used by the ILD is breaking new ground. (The methodology used is covered in depth in Module 2, Economic Analysis of Informality and in Module 3, Institutional Reform).

Early research completed by the ILD is frequently deepened to provide insights into particular aspects of an issue. An example is the research conducted in 1988 on the concepts of Possession Title for informal property holders and Popular Mortgage (Hipoteca Popular), both relating to the ILD's initial research conducted on the informal housing sector. This effort resulted in institutional reform proposals adopted by the Peruvian government in July 1989 and now being implemented as national programs, with assistance from the ILD.

Multidisciplinary research teams are organized into task forces, or "work circles," each headed by a lead researcher, and involving combinations of lawyers, economists and other professionals, with assistance at times from historians, anthropologists, political scientists and sociologists. This organization enables the circles to respond to research needs with speed and flexibility. Any of the 20 the ILD researchers may be assigned to work on one or several of the projects. The work circles have access to two senior research advisors who serve as technical consultants, one for economic research and one for institutional research.

FIGURE 1

ILD ORGANIZATION CHART



*Duties executed by General Manager

The circles are formed to address specific, high-priority problems in a given economic sector or institution. Each circle is responsible for formulating a proposal for institutional reform at the end of its task. Once the proposal is put forth, several members of the circle may continue their involvement to promote and implement the proposal.

The ILD has found that eight circles is a practicable number. (See **Figure 2** for a schematic of the eight current research circles). This allows the ILD to deepen the level of understanding in certain fields and concentrate on results on the level of institutional reforms which can be practically adopted by public institutions.

Each research circle is responsible to the Technical Committee, formed by the President, the General Manager and the Economic and Institutional Research Advisors, which regularly reviews research progress. The Technical Committee and individual circles set milestones and dates for completion of reports on the research they are conducting. The circle leaders are accountable for the quality and pace of work. Using this system, the ILD has remained on target for all its major research efforts.

Due to the constantly changing nature of politics and economics in Peru, the research program is occasionally adapted to externalities, e.g. windows of opportunity that present themselves due to the particular interest of the President of Peru or other senior government officials in pursuing a given reform. One example is the priority accorded to the Administrative Simplification program in August 1989 when President Garcia decided to accelerate the implementation process. Resources from both the Research Division and the Promotion and Implementation Division were brought to bear to move ahead quickly to implement the reform.

The ILD participated in a March of Peace in November 1989, also as a political (though non-partisan, i.e. "pro-peace" gesture). The Democratic Rulemaking initiative has also been picked up recently by the President of Peru to bolster the administration's image in the closing months of its term.

The approach of the work circles in general is to:

- Determine the nature of informality in the sector being investigated by identifying and interviewing key formal and informal respondents in order to:

  - identify the factor markets and economic sectors in which informality occurs

  - identify and study the reasons for the existence of that informal activity

  - quantify the extent to which it occurs

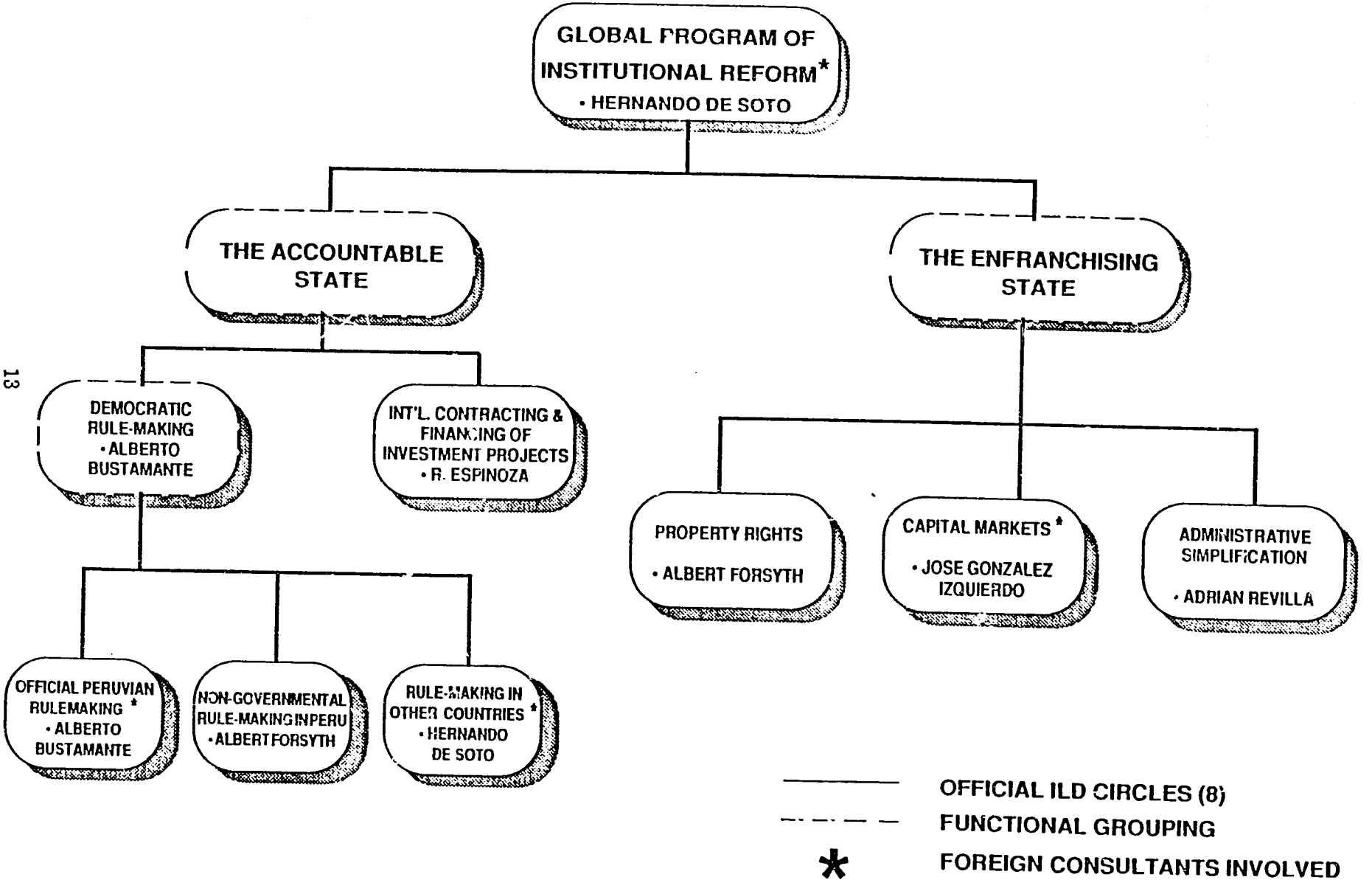
- Refine and apply the methodology for measuring the costs of legal and institutional barriers to:

  - single out certain of the more significant costs and analyze the interaction of these inefficiencies in the different markets and sectors, thus clarifying the effects of one sector on the rest of the economy

  - develop a methodology generally applicable in developing countries

112

ILD RESEARCH CIRCLES
10/89



- Examine the nature of local and international approaches to institutional solutions through:

  - analysis of the extralegal norms developed by the informal sector to replace existing, inefficient legal and economic institutions

  - conduct of comparative international research to identify similar problems and their solution in other countries, and analysis of these solutions to determine whether they could be adapted to Peru's situation

- Develop and evaluate alternative solutions, based on the above, that could remove or minimize the more disruptive structural barriers to economic and political participation.

- Once the best solution is agreed upon, it is structured into a draft law or public policy proposal for reform which is published and subjected to public scrutiny and debate. The ILD's experience in this matter has shown that if the proposal is well-designed, it will be endorsed by the authorities. If not, it will be enriched by the debate and returned to the drawing board for a comprehensive review and re-initiation of the process.

2. Promotion and Dissemination Division

The role of this division is to communicate the ILD's findings to a broad public, both formal and informal, to test research results, and to build support for proposed reforms, both at the grassroots level and with decision-makers.

The ILD has developed the following techniques to create a successful public information campaign:

- Select issues on the basis of their relevance to the broadest stratum of the population: the poor (e.g., property rights for informal settlements).

- Set forth arguments based on reliable, factual data gathered directly from both the informal and formal sectors so that people identify with the points being made.

- Reinforce democratic concepts in the program by making all legislative or policy proposals available for comment and review before final publication.

- Communicate with target groups through popular press, magazines, radio and TV channels, and use the informals' networks to distribute information in the informal sector.

To facilitate its contacts outside Peru, the ILD has established a liaison office in Washington, D.C.

The national and international dissemination efforts and feedback processes are discussed in detail in Module Four, Effecting Change Through Advocacy.

116

3. Finance and Administration Division

This division handles internal accounting and payments and financial reports to donors. A staff of six persons is responsible for these tasks.

B. OUTSIDE CONSULTANTS

A key asset of the Institute from the very beginning was its access to a select group of consultants in highly specialized fields who could bring to bear their expertise on the problems encountered in Peru. When de Soto first began his research on informality, he sought advice from eminent legal scholars in the Western world. Not all of these persons were able to relate their expertise to the problems of street vendors or squatters in Peru, but those who could make the transition were of invaluable assistance to the Institute.

Among the most important contacts of the Institute are Professor Warren Schwartz of the Georgetown University Law School, Robert Litan, senior economist at the Brookings Institute, Peter Schuck and Jerry Mashaw of the Yale Law School, Saul Levmore of the University of Virginia Law School, Douglass North and Lee Benham of the Washington University's Department of Economics, Edgar Feige of the University of Wisconsin, Thomas Hopkins of the Rochester Institute of Technology, Michael Block of the University of Arizona's School of Economics, Frank Swain, a specialist in small business administration, Mestmaecker, senior associate at the Max Planck Institute and David Becker of Jacksonville University.

The ILD has finetuned its approach over the years so that it is able to quickly and effectively make use of experts' time by posing questions, based on its own knowledge of the problems in Peru, to determine what solutions in the expert's field might be most applicable to Peru. A recent example is the assistance provided by Mr. Oscar Beasley, Chairman of the Title Insurance Company in California, who provided extremely practical and useful suggestions on how to establish a title insurance operation on a large scale in Peru.

IV. LESSONS LEARNED

1. Crisis creates political opportunity which must be exploited. The economic situation in Peru is so serious that both of the recent presidents, particularly as their mandates reached expiration, were motivated to consider radical changes in local institutions to improve the situation.

2. Grassroots support is a key element in effecting change. Although a window of opportunity presented itself to the ILD before the end of the Belaunde presidential term, the ILD did not have sufficient time to establish firm grassroots support which could have made the difference in whether or not its regulatory analysis proposals were implemented. As it was, the decree was ignored. However, today that grassroots support has been firmly established and informals, and other economic groups, are prepared to weigh in strongly to support the ILD's institutional reform initiatives and to ensure a bottom-up versus a top-down approach.

3. Local researchers and activists should rely on their own instincts and analysis to find solutions adapted to their particular local circumstances. Although the expertise of foreign advisors is often useful, intellectual imperialism from foreign experts must be avoided.

4. In providing new data to inform the policy making process, government officials can be convinced that reforms, even major reforms, are in their interest also.

5. The media plays a key role in bringing issues to light and in transmitting the needs of the poor majority to the government.

GLOSSARY

Accountable State	A state in which rulemaking takes into account the opinion of experts and those persons affected by the proposed rules
Advocacy	The act of or speaking, writing or acting in support of a cause. In the case of the ILD, advocacy includes public education on institutional reform issues, measures to obtain feedback from the public on those issues and initiatives to disseminate the ILD's thesis to national and international audiences
Ambulantes	Street vendors in Peru
Enfranchising State	A state in which access to economic activity is open to all rather than restricted to the few
Mercantilism	The economic doctrine prevalent in Europe with the decline of feudalism and through the eighteenth century that protected selected local industries through tariffs on imports and the creation of monopolies; those parties with access to power obtained important privileges
Property Rights	The degree to which owners of any asset, including contracts that promise the delivery of assets, goods or services, can use these resources, buy, sell or otherwise dispose of them; i.e., can exclude others from their use
Pueblos Jovenes	Shantytowns built by informals on the outskirts of Lima (literally, "young towns")
Rulemaking	The process by which laws and regulations are made in a given country
Tied Credit	Credit supplied usually by or through foreign donors whose use is contingent upon contracting with firms from that donor's country for construction or supply of goods or materials

REFERENCES

de Soto, Hernando, *The Other Path*, New York, NY, Harper & Row, 1989

Dozer, Donald M., *Are We Good Neighbors?*, Gainesville, University of Florida Press, 1959

Feige, Edgar, *The Underground Economy*, London, Cambridge University Press, 1987

North, Douglass and Robert Paul Thomas, *The Rise of the Western World*, London, Cambridge University Press, 1973

North, Douglass, *Sturcture and Change in Economic History*, London, Cambridge University Press, 1985

Olson, Mancur, *The Rise and Decline of Nations: Economic Growht, Stagflation and Social Rigidities*, New Haven, Yale University Press, 1982.

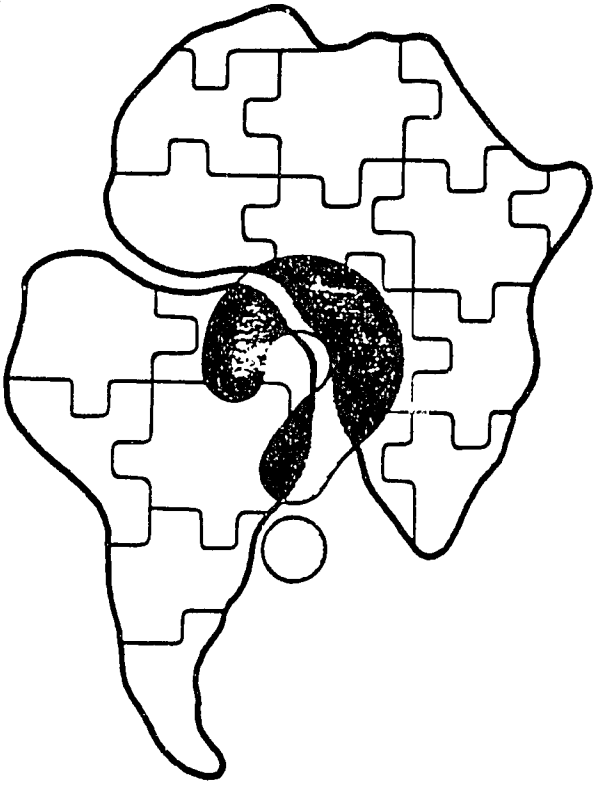
- SECTION 2 -

ILD TRAINING PROGRAMS: MODULE 2

TRAINING PROGRAM FOR AFRICAN RESEARCHERS
IN ECONOMIC ANALYSIS OF INFORMALITY
AND INSTITUTIONAL REFORM

MODULE TWO:

ECONOMIC ANALYSIS OF INFORMALITY



November 27, 1989 – December 5, 1989

Sponsored By:

Institute for Liberty and Democracy
Lima, Peru

Agency for International Development
Bureau for Africa, Office of Technical Resources

MODULE TWO
ECONOMIC ANALYSIS OF INFORMALITY

TABLE OF CONTENTS

I. INTRODUCTION 1

A. OBJECTIVE OF THE ILD'S RESEARCH 1

B. PURPOSE OF THE MODULE 2

II. MACROECONOMIC MEASUREMENTS OF INFORMAL ECONOMY 2

A. RATIONALE FOR THE USE OF A MACRO MODEL 2

B. DESCRIPTION OF THE ILD'S MONETARY METHOD 3

C. ESTIMATION OF INFORMAL MAN-HOURS 4

III. MICROECONOMIC MEASUREMENTS OF INFORMAL ECONOMY 4

A. METHODOLOGY 4

1. Acknowledging the "Long Frontier" 4

2. Model for Gathering Information 5

a. Selection of Informants 5
b. The Interview Process 6

3. Special Projects and Sources of Information 6

a. Simulations and Case Studies 6
b. Other Resources 7

4. Economic Analysis of Law 7

B. HOUSING 8

1. Methods Used by Informals to Acquire Property 8

a. Invasion 8

(1) Invasion Strategies 8
(2) Informal Organizations 10
(3) Extralegal Norms for Housing 10

b. Illegal Land Sales 11

C. TRADE 12

1. Types of Informal Trade 12

a. Street Vending 12

(1) Itinerants 12
(2) Fixed Location Vendors 13
(3) Extralegal Norms for Trade 14
(4) Self-defense Organizations 15

b. Informal Markets 15

(1) Markets & Fairgrounds 15
(2) Promotional Organizations 16

D. TRANSPORT 16

1. Types of Transport 16
2. Invasion 17
3. Informal Transporters' Organizations 17

E. MANUFACTURING 18

IV. SIMULATIONS TO DETERMINE LEGAL CONSTRAINTS 18

A. BUSINESS REGISTRATION 18

1. The Costs of Access to Industry (289 days) 18
2. The Costs of Access to Trade 19

a. Store (43 days) 19
b. Market (17 years) 19

3. The Costs of Access to Transport 21

B. LAND ADJUDICATION AND DEVELOPMENT FOR HOUSING . . . 21

1. Request for Adjudication 21
2. Approval for Land Development 22
3. Building Permits 22

V. CONCLUSIONS FROM THE ILD'S RESEARCH 22

A. INEFFICIENT LEGAL, POLITICAL & ADMINISTRATIVE INSTITUTIONS 23

B. INSTITUTIONS AND THEIR RELATION TO TRANSACTION COSTS 23

C. THE COSTS OF FORMALITY AND INFORMALITY 24

1. The Costs of Formality 24
2. The Costs of Informality 25

a. The Costs of the Absence of Good (Facilitative) Law 25
b. The Costs of Illegality 25

D. NATIONAL ECONOMIC CONSEQUENCES 27

E. THE PARALLEL WITH MERCANTILISM 28

VI. NEW PROGRAMS OF ECONOMIC RESEARCH 28

A. CAPITAL MARKETS 29
B. FOREIGN TRADE 29

GLOSSARY 30

NOTES 33

MODULE 2

ECONOMIC ANALYSIS OF INFORMALITY

I. INTRODUCTION

> "The methods and research which went to make up [*The Other Path*] evolved from my doubt about at least three fairly widespread assumptions concerning the situation in Peru: ... that informality—slums and shantytowns, small industry and many activities which Peruvians carry on illegally—represents only poverty and marginalization; ... that Peruvian culture, ... which we associate with the rural areas, is incompatible with the entrepreneurial spirit and economic systems of more developed countries; ... [and] that all the evils which assail Latin America are generally not our fault but almost always the result of some external force ...
>
> I was convinced that no serious research could be conducted on the basis of prejudices which no one had been able to substantiate fully, and which reflected an inability to understand or appreciate Peruvians' true potentialities."
>
> Hernando de Soto, *The Other Path*

Central to the ILD's analysis of the problems of underdevelopment in Peru has been its use of **empirical methods of research**: careful observation and measurement of the Peruvian economy. Putting aside preconceived notions and traditional cultural and ideological theories for why Latin American and other Third World countries remain poor, researchers from the ILD have used a variety of techniques, including interviews and surveys, simulations, and study of existing documents to draw conclusions about economic activity in Peru, with emphasis on informal sector activities.

The ILD's methods and results have been instructive and informative, not only in describing the situation in Peru, but in providing both a methodology and a base for comparison with other underdeveloped countries in Latin America, Africa and elsewhere. In addition, although the ILD's initial research focussed on the informal sector, the implications of its findings, particularly regarding the need for institutional reform and facilitative law, apply to both the formal and informal sectors.

A. OBJECTIVE OF THE ILD'S RESEARCH

The ILD's thesis is that the informal sector should be viewed as a dynamic and efficient economic response to the institutional costs and constraints imposed by a legal system that systematically excludes a large segment of the population from the normal protections afforded by property rights, contract enforcement and torts.

The bulk of the research undertaken by the ILD has consisted of efforts to describe the institutional evolution of the informal sector and to identify the causes and implications of that evolution. The major part of the research effort has been devoted to an investigation of the costs of entry into the formal sector by intensive field studies of the barriers erected by the existing legal systems.

The Institute's strategy involves empirical observation of economic activity in two aspects: measurement of the activity in question, and examination of the discrepancies between mercantilistic economic activity and entrepreneurial activity as practiced by the informal and formal sectors.

B. PURPOSE OF THE MODULE

The purpose of this module is to describe the macro and microeconomic measurements of the informal economy which were made by the ILD and to present the conclusions reached by the ILD based on this research, particularly as regards the costs of formality and informality, the parallels with mercantilism and the need for legal, political and administrative reform.

Upon completion of the module, participants should have a clear understanding of the methodology employed by the ILD for its measurements, the results of the measurements undertaken, and the conclusions reached regarding dysfunctions in the Peruvian economy and institutional framework which have resulted in such large scale informal sector activity. This understanding should prepare participants for planning and carrying out their own programs of research on economic activity in their home countries.

II. MACROECONOMIC MEASUREMENTS OF INFORMAL ECONOMY

In order to get a global picture of the size of the informal sector and its impact on the economy, the ILD undertook two studies designed to provide the macroeconomic framework within which to situate its microeconomic sector studies. The macro studies were based on the analysis of aggregate economic variables in order to arrive at a preliminary overall quantification of the importance of informal economic activity in the country.

The first study summarized and consolidated the different results that could be obtained from government statistics and reports. The second study attempted to quantify the size of the informal economy through monetary analysis, from a macroeconomic viewpoint.

The results of these studies were not totally satisfactory, and the ILD has since refined its methods, and concentrated on microeconomic sector studies, which have yielded more detailed results. Nonetheless, in observations of informal economic activity from a macroeconomic perspective, the ILD was able to determine that by 1985, the informal sector represented 48 percent of the active labor force in Peru, accounted for 61 percent of the total hours worked in the country, and generated 39 percent of the Gross Domestic Product (GDP).

A. RATIONALE FOR THE USE OF A MACRO MODEL

Because of the difficulties involved in estimating the total extent of a phenomenon whose distinguishing characteristic is that it defies detection, the ILD followed an eclectic approach, quite independent from all well-known intrusive or microeconomic methods.

125

The ILD was aware that the risk of obtaining high non-response rates and false reporting, and thereby underestimating informality, was proportional to the size and scope of the survey. Moreover, large scale surveys are not only costly, but at best provide only point-in-time estimates that preclude the examination of the dynamic aspects of informal activity growth over time.

It is for these reasons that the ILD has devoted considerable attention to the use of unintrusive macroeconomic methods as a complement to its microeconomic research efforts. One of these is the monetary method, which seeks to identify the amount of excess currency demand which could be attributed to informals, and to thereafter estimate the volume of production this amount of currency actually generated. The monetary approaches to estimating the size and growth of the informal sector have been applied in a number of countries (e.g., the U.S., Europe and Latin America). Although they have well recognized shortcomings, monetary methods provide a means of independent estimation that can be used as a consistency check on the findings from alternative methods. The monetary methods rely on readily available macroeconomic sets and thus have the advantage of being less costly to employ. Moreover, because the methods are based on clearly specified models, their results can be readily replicated and subjected to standard sensitivity tests to examine their robustness under alternative specifications. Finally, because these approaches rely on monetary data that have been collected for purposes totally unrelated to informal activities, they have not been contaminated by the non-response biases or false reporting biases that are common in microeconomic survey methods.

The ILD's adherence to the monetary approach is based on the evidence collected as a byproduct of two surveys conducted in Lima on informal capital markets. A 1986 ILD pilot survey found that not more than 20 percent of informal transactions are affected by checks, while a broader 1987 survey by the Universidad del Pacifico on the flow of funds in the informal sector revealed that less than two percent of informals had checking accounts.

These results suggest that there is a direct relationship between the use of currency and the development of the informal sector. This relationship was already noted in the United States by Cagan (1958), although the rationale for the use of currency in Peru is different from that in the U.S. Peruvian informals do not employ currency as a means of evading taxes, but rather out of necessity, due to the barriers erected by an oligopolistic banking system to the opening and use of checking accounts by informals (registration requirements, e.g. tax registration cards, payment vouchers, etc.; and difficulties faced by informals in collecting unpaid checks through legal actions).

B. DESCRIPTION OF THE ILD'S MONETARY METHOD

The ILD's method, inspired by Feige's generalized currency ratio approach (GCR), is based on the assumption that there is a stable relationship between the demand for currency relative to demand deposits (i.e. the C/D ratio) and the volume of informal transactions. Therefore, the emergence and growth of the informal sector, where transactions are mainly carried out with cash, alters the size of the observed ratio.

As long as the effect of informality can be predicted by means of an adequate regression equation, it will be possible to determine the volume of currency which serves to carry out informal transactions. By making reasonable assumptions about the income velocity, the amount of informal GDP produced by this amount of currency can then be estimated.

The informal income estimated for Peru with the best regression equation amounted to 39 percent of total GDP in 1985. Subsequent calculations with additional data and more sophisticated econometric corrections have only slightly changed the magnitude found with the first calculation.

C. ESTIMATION OF INFORMAL MAN-HOURS

These calculations were based on the ILD's estimation of total informal GDP, and the National Institute of Statistics' estimates of the number of workers in each sector which are officially considered as underemployed. In order to obtain a more reliable representation of the role of the informal (fulltime as well as part time) workers' activity in various economic sectors, it was necessary to reallocate labor resources that were initially classified by sectors of origin to the appropriate sector of destination, namely to the major sectors where informal activity was believed to take place.

The need to reclassify man-hours to their appropriate destination required a set of explicit assumptions that were informed by institutional knowledge based on interviews in the field. For example, field interviews revealed that informal agricultural workers were only able to work in the agricultural sector for approximately six months of the year, due to the seasonal nature of the demand for their services. For the remaining six months these workers' activities were devoted—and hence allocated—to informal activities in the trade and other service sectors. Similarly, the additional part time man-hours of formal workers, initially classified by sector of origin, were reallocated the sectors of destination where their informal activities actually took place. Using this procedure the ILD found that 61 percent of total man-hours worked in Peru were informal in 1985.

III. MICROECONOMIC MEASUREMENTS OF INFORMAL ECONOMY

A. METHODOLOGY

Given the ILD's doubts about traditional hypotheses on informality—i.e., that it represents poverty, exploitation and marginal subsistence; and that Peruvian culture is incompatible with the business spirit and market economy of Western developed nations—the Institute decided it was necessary to obtain a picture of informality based on the experience of the informals themselves. A key element was the use of informants to provide direct information about informal activities.

The methodology is divided into four parts: the concept of the "long frontier" emerging from initial interviews; the model for gathering data; the special projects and sources of additional information; and the economic analysis of law.

1. Acknowledging the "Long Frontier"

Because of the ILD's awareness of the importance of the effects of law on society, it began its work by considering why so many people occupy the streets, roadsides and vacant lots of Lima, in order to establish anonymous industries. Through initial interviews, the ILD discovered a number of key points: that anyone seeking to legally acquire land, build a house or set up a business faces a costly and time-consuming process of obtaining all the licenses and permits required by government authorities. In addition, the ILD discovered that once a person had entered into a formal business, there were other regulations to be followed in order to remain legal, and that these too had

costs. It was determined that because of these costs, it was neither automatic that a person wishing to conduct an activity would choose to do so in the formal sector, nor that a person already operating in the formal sector would always remain formal.

This observation led to the concept of the "long frontier" between the formal and informal sectors, a gray zone where people move between informality and formality over time, or where people may be simultaneously conducting activities that bridge both sectors.

The existence of this gray zone posed problems of measurement. In order to accurately assess the magnitude of the informal sector, its evolution and effect on the economy over time, the ILD identified as "informal" all those activities which had their beginning in informality (land invasions for housing, route invasions by transporters, itinerant traders, etc.) even if some or all of their activities could later be considered in the formal sector.

2. Model for Gathering Information

The information gathering effort included several activities. Where possible, a census was taken of informals involved in a certain sector, (e.g. trade, transport, housing) to determine the overall size and scope of the activity. This census was followed up by surveys conducted among smaller groups within each sector to gather more data about the activities. The interviews were conducted by using a form of the "Delphi" method.

a. Selection of Informants

The ILD identified persons operating on the long frontier between formality and informality as its key informants. The ILD looked for informal businessmen who were not only well informed about their own activities but also possessed information about informality overall. The ILD looked for people with expertise, access to information where there was no direct knowledge, ability to summarize information, and lastly, credibility.

These people included:

- business owners who had been, or still were, engaged in informal activities, successful in their trade, in business for more than five years, and who played a leadership role in their respective sectors and/or in formal or informal business associations;
- appointed block leaders or area group leaders in informal housing settlements, particularly those from areas of the city where such developments were more concentrated;
- bus committee leaders, especially former bus drivers with extensive experience;
- elected leaders of local street vendor associations;
- leaders of formal and informal small business associations;
- specialists and professionals (lawyers, economists, engineers) acting as technical advisors to informal organizations seeking to plan informal communities, set up bus routes, build markets, etc.;

police, civil guard, and government employees with responsibilities related to the areas of housing, commerce, industry, labor transport, etc.

Identifying and setting up talks with these kinds of people is an enormous task, as many of them are not visible, and the activities of the state agencies dealing with them are relatively low-keyed.

At the public symposium organized by Hernando de Soto in 1979 on "Democracy and the Market Economy," a key group of 20 of the most visible street leaders in the city of Lima made presentations and participated in the debates. Newspaper coverage of the event led to their recognition as important social elements, which in turn led the street leaders to introduce the ILD to the informal world. A second symposium two years later targeted more specific kinds of informal activities and as a result, the ILD was able to assemble an important spectrum of key sources of information, who led the researchers in turn to other informants.

b. The Interview Process

The ILD used the "Delphi/Key Informant" survey method, which uses a panel of experts to interview and evaluate information from targeted key informants. Key informants are usually persons with some special access to the information sought, although they may not necessarily be experts on the precise subject being surveyed. The ILD's study was unusual in that its experts and key informants, primarily from the informal sector, turned out to be competent and knowledgeable people rarely used in studies of this kind.

The interviews were carried out by an interdisciplinary team made up of experts in law, economics and urban anthropology. Informants were interviewed in groups, and individually. After answering general information questions, informants were presented with the team's tentative theoretical formulation which was developed to obtain the informant's assessment, criticism and suggestions. This feedback allowed the researchers to develop realistic analyses, by touching base with the social reality as seen by the informant.

In followup interviews, the team used more focused questions in an attempt to reduce the variance in responses among the informants on a certain subject.

Following each interview, the team members would write a summary of the information they had obtained, including any theoretical considerations that seemed pertinent. This allowed for codifying the information into categories and the development of a theory based on observations.

Most informants were paid for the time they spent with the researchers, and for any additional information gathering they were asked to do. Some of the informants became in effect co-researchers, contributing ideas and analyses of informants' experiences.

3. Special Projects and Sources of Information

a. Simulations and Case Studies

In order to get a clearer picture of the legal and institutional restrictions facing Peruvians of modest means, the ILD conducted a number of simulations, which are described in detail later in this module. In each case, a group of researchers simulated

129

the startup of an activity—establishing a small industry or store, applying for land adjudication, etc.—in order to trace the number of steps and the amount of time and money involved in complying with government regulations. This allowed the field researchers to better understand the problems described by the informants, and highlighted the importance of the study of legality as a key issue in determining why people turn to the informal sector.

Where it was impossible for reasons of time to conduct simulations (e.g. building a market, creating an informal settlement) the ILD used indirect methods. The teams studied various existing cases and examined legal standards, combining both mechanisms with the perceptions of officials and former officials about the duration and level of difficulty of normal procedures.

b. Other Resources

The main sources of statistical data were the National Institute of Statistics, the Ministry of Labor and the Central Reserve Bank, as well as other ministries dealing with the subject area. These data were used to conduct studies dealing with the macroeconomic measurements described above in Section II, as well as to provide base statistics with which to compare the results of the ILD's census and survey work.

A literature search was conducted among the archives of government and private organizations in Lima, to look for studies of informality made in Peru or abroad. In addition, a bibliographic search was made, including requests for bibliographic information and unpublished studies from foreign consultants and government or international groups contacted during the course of the study.

Historical research, covering the pre-Columbian, Colonial and Republican periods of Peruvian history was also conducted, to determine the precedents for current socio-economic conditions, market distortions and legal institutions, as well as the kinds of informal solutions chosen by the poor when they found themselves excluded from formality in the past.

Foreign specialists were consulted in the areas of economics, law and anthropology, in order to be aware of recent discoveries in various fields, and to relate the study to the development of such work in other countries. At the same time this international perspective made it possible to identify what kind of corrective measures had been taken in other countries, in order to determine which elements were successful, which in turn helped in formulating policy recommendations.

4. Economic Analysis of Law

Once the information was gathered, the analytical challenge was to study the behavior of informals and propose an explanation for it. Economic analysis of law was chosen as the appropriate theoretical framework for understanding the interactions among formal and informal activities. This made it possible to explain the behavior observed as a whole through a simple organizational principle: people always maximize their profits within the restrictions they have to face. This means that people are cost-sensitive to the choices they must make in order to reach their goals, and they maximize their satisfaction when they are conditioned mainly by their own goals and the cost of attaining them. An important contribution of the economic analysis of law was that it highlighted the importance of institutions in the definition of behavior of the economic

agents, both formal and informal, as well as showing that informals did not have access to certain facilitating factors of the law which—as in the case of guaranteed contracts or stable property—are essential for a person to achieve optimum economic status.

The sectoral studies described below, (as well as current research projects) make use of the above methods, which the ILD has modified as needed. In summary, the ILD model for information gathering makes extensive use of interviews, case studies and review of documents. Once key areas or sectors of the economy for analysis are identified, work begins to determine the structure and size of that sector or activity, identification of legal rules that impinge on the activity, description of steps to comply with those regulations, field studies, including extensive interviews with informants, to estimate the costs of complying with the regulations, and cost-benefit analysis of legal and administrative restrictions.

The results of the ILD's sectoral studies are described below.

B. HOUSING

In the past four decades, the population of Lima has grown by 1200 percent. Much of this growth has been by informal means. Of all the housing in Lima in 1982, the ILD calculated that 42.6 percent was in informal settlements, 49.2 percent was in formal neighborhoods, and the remaining 8.2 percent was found in slum areas within these neighborhoods. This means that for every ten formal dwellings in the capital city there are nine informal ones. Of the capital city's total population in 1982, 47 percent lived in the informal settlements, 45.7 lived formal neighborhoods, and the remaining 7.5 percent lived in slum areas. Informal housing construction over the last 20 years is valued at $8.3 billion, all generated by the informal class. During the same period, the government built popular housing worth $174 million.

1. Methods Used by Informals to Acquire Property

The ILD has identified at least two ways of acquiring property informally for housing purposes. The first is "invasion", the second is illegal purchase of agricultural land through associations and cooperatives.

a. Invasion

(1) Invasion Strategies

State or private land is occupied illegally in one of two ways—"gradual invasion" or "violent invasion." The first takes place progressively in existing settlements. These settlements are often farmworkers' huts attached to farms or estates, or to mining camps, where the occupants are usually employees or tenants of the farm or mine owners. The owners usually attach little importance to the land and have little interest in evicting the occupants. They are more concerned with having a ready labor force close at hand. However, over time, new groups of people who have no relationship to the owner gradually join the settlement, because they have relatives there, acquire a piece of land, rent it, or simply take it over. In this way they gradually occupy the land adjacent to the original settlement until they effectively "own" the entire area.

Settlements formed by gradual invasion take on definite shape only after a lengthy process. Nonetheless, this kind of takeover requires a critical mass of settlers which can exert pressure on and negotiate with owners in order to dissuade them from trying to recover their land.

In the second kind of invasion, there is no prior link between the settlers and the owner of the land, which is why the invasion is "violent" and unexpected. Usually, however, this kind of invasion is the result of complex, detailed planning. The ILD has observed that normally such an invasion begins with a meeting of a group of people from a given neighborhood, family, or region, who all have an interest in obtaining housing. This group is usually joined by professional invaders—generally trade unionists, politicians, or business people—who offer their expertise in exchange for political or economic concessions.

Once an original nucleus has been established, a series of meetings is held to find a location which meets the requirements for a settlement. Although both private and public lands have been occupied in this way, over 90 percent of the violent invasions have occurred on state land; usually on waste or unoccupied land. This is easier than trying to take over private land, as there is no one individual affected by the act, and political considerations may make the government unwilling to oust the settlers.

Once the land has been chosen, the original group works to show all interested parties the advantage of working together on an invasion rather than attempting individual acts. This is considered crucial to reducing the possibility of police repression or reinvasion of the settlement by individuals who seek to occupy the free areas.

Once there is a common agreement to work together, engineers are brought in to draw up a plan of the new community. Individual lots are delineated, as are places for future public buildings (schools, health centers, or municipal authorities), and recreation areas (parks or sports grounds). A census is taken of the invaders and the contribution each will make to common costs is approved. Responsibility for negotiating with the authorities, preserving law and order in the settlement, and organizing resistance against eviction (by forming settlers' pickets) is assigned. Often a group will hire lawyers and make a formal request for adjudication of the land to the settlers. In this way invasion leaders can say they have legally requested the land be adjudicated to them and are occupying it to keep other potential—and often nonexistent—invaders from occupying it illegally.

Once the preparations are made, the invasion is carried out, usually at night, and often on a public holiday, to reduce the chance of a rapid response by the forces of law and order. Invaders arrive en masse, in trucks and minibuses, carrying poles and matting to erect their first dwelling, and Peruvian flags to show their patriotism. The settlement is demarcated with powdered chalk and people put up their dwellings. Communal kitchens are set up, as are day care centers. In addition, contact is made with local minibus operators to provide transportation service to the new community. Eventually, street vendors will appear to begin providing everything from food to building materials.

In order to defend the new settlement, invaders use a variety of tactics, including defense pickets armed with sticks and stones, and will often put women and children on the front line to intimidate police into not using force. Also, group leaders will often name the new community after the current president, his wife, or other prominent political figures, in an attempt to persuade that person to intervene on the settlement's behalf with authorities.

(2) Informal Organizations

Virtually all informal settlements have elected bodies which execute the invasion contract. These groups all have a basic clear-cut organizational structure consisting of a central leadership—the executive body, and a general assembly—the deliberative body. This is in contrast to the official government structure in Peru and other countries, where legislative and executive powers are concentrated in the government cabinets, rather than in democratic organizations.

These organizations perform a whole range of functions, including negotiating with authorities, preserving law and order, trying to provide services (e.g. public works; water supplies, sewers, electricity and roads), registering the properties in the settlement and administering justice.

(3) Extralegal Norms for Housing

Although it might be thought that life in the informal settlements is anarchic and disorganized, in fact a number of rules for governing social relations, termed "extralegal norms" by the ILD, are created by the informals, in the absence of the official legal system, to serve their needs.

The ILD has identified two sets of extralegal norms adopted by the informals in the area of housing. The first is known as the "invasion contract," and is the set of agreements established by those who invade a piece of land. The agreements govern the establishment of the settlement, including distribution of land, mechanisms for governing the settlement, and defence of the residents' interests in exchanges with the authorities.

Informals have also devised a form of property right, referred to by the ILD as "expectative property right." This is a provisional property right established by the invasion which serves in lieu of official property rights so that informal settlements may register, rent or sell their land, in expectation of obtaining legal title to it. (More detail on these extralegal norms is provided in Module Three.)

Because these extralegal norms are, by their nature, not officially recognized by the government, those living in informal settlements face a great deal of uncertainty as to their claim to their land. The ILD has found this uncertainty has a direct effect on the level of investment a person will devote to improving his or her property, as can be seen in the example below.

133

Example: Castilla & Alcides

To see how access to property rights can affect individual and community welfare, the ILD examined two communities side by side, the Mariscal Castilla and Daniel Alcides Carrion informal settlements. Both were built during the same time period, and inhabited by people from the same socioeconomic background. However, where Castilla's first mayor had worked to classify his settlement as permanent, Alcides remained classified as removable.

As a result, the value of land in Castilla was estimated to be 12 times greater than that in Alcides, where there was no legal security; while the value of a typical dwelling in Castilla was 41 times higher than the dwellings in the Alcides. Castillans lived in three and four story houses of brick, often with well kept stores on the ground floor level. Many of the houses had neat gardens, while the streets had paved sidewalks.

However the inhabitants of Alcides, who could be removed at any time, lived in crude huts made of mud bricks, or cardboard and plywood. The passageways between the houses were muddy and filled with garbage. Those inhabitants of Alcides who could afford to buy anything put their money in cars, televisions and other goods which could be carried with them, rather than investing in more expensive and secure structures, which could be bulldozed.

In fact, the ILD has determined that people who are able to gain title to their land will put nine times more investment into their property than those who have no title.

b. Illegal Land Sales

A second informal way to acquire property for housing is to buy land illegally through associations and cooperatives.

Under the agrarian reform of the 1970's, the government called for private farmland to be expropriated and redistributed to the peasants. This prompted many farm owners to seek to sell their land, driving down the value and making it affordable to large sections of the population who had benefited from a concurrent growth in the informal economy (minibus operators, street vendors, and clandestine industries). This gave rise to the second method of acquiring land: settlers would collude with owners of agricultural land on Lima's outskirts who feared expropriation.

The potential settlers would organize themselves into associations or cooperatives—groups recognized and protected by the state—and then strike a deal under the table with the land owner to gain possession of his land. At times, the settlers even simulated an invasion, as a diversion, with the approval of the landowner who had already agreed on terms of sale. In this way landowners transferred their land for less than the normal

price but for more than if it had been expropriated, while the associations gained good land at reduced prices, avoided the hazards of a violent invasion, and gained slightly more secure property rights.

This kind of transfer of land inevitably involves the assistance of professionals who can assemble the information needed to make this kind of transaction. These people, known as "speculators" are a form of informal real estate broker, who set up the association or cooperative, identify the land, and then negotiate the transaction.

C. TRADE

The large number of street vendors and informal markets in Lima led the ILD to look at these groups as a major force in the country's economy.

In 1985, the ILD conducted a census and found that there were 91,455 street vendors in Lima. Further surveys revealed that these vendors represented 42 percent of the labor force involved in commerce, distributing approximately 60 percent of the food in the city and earning an income almost 40 percent greater than the minimum wage.

In the informal markets, where street vendors have banded together to sell their products in specially constructed markets, the ILD found that former street vendors have put up 274 markets and commercial centers, or 83 percent of the markets in the capital city, worth $40.9 million and employing 40,000 individuals. By contrast, the government has constructed only 57 markets. Today 11 out of every 12 markets under construction are being built by street vendors, while only the twelfth is being built by the government.

1. Types of Informal Trade

Generally speaking, the types of informal trade in Peru fall into two categories—street vending and informal markets—although these are not separate activities but rather different stages in the same process. People who begin as street vendors aspire to moving eventually into a market, where working conditions are better. Virtually all traders working in markets started on the street.

a. Street Vending

The ILD found two general categories of street vendors, those who walk around the city offering goods or services without a fixed point from which to operate, and traders who sell merchandise or services from a fixed location on the public thoroughfare.

(1) Itinerants

Itinerant vendors generally purchase small quantities of items, being limited to what they can carry, and walk the streets in search of customers. Their income depends on their skill in finding customers, since there is no way for customers to find them. They also usually have little capital or access to credit. Their transactions are generally handled in cash.

As these itinerants become more experienced, they observe prices, sales methods and locations used by other vendors, and learn to negotiate with suppliers and clients. They also begin to identify established routes, with regular customers, and acquire carts which allow them to carry more goods and increase the scale of their operations. This repetitive

use of certain routes also allows them to establish a reputation, enabling them to gain the trust of customers and to obtain credit from regular suppliers. Eventually the vendor is able to identify a location that is commercially attractive for selling goods, and will seek to establish a fixed location.

(2) Fixed Location Vendors

When a vendor decides to set up in a fixed location, an invasion of the street occurs. The ILD found that, as with the settlers, street vendors do not invade the streets arbitrarily or haphazardly, but only after a complex economic calculation.

The vendor evaluates the value of the location, in terms of numbers of customers, potential sales, anticipated net income, and sets prices for his products. The vendor also examines other factors, including potential resistance from other established vendors in the same location, residents who may be harmed by the activity, and the authorities. Usually these factors are handled by making prior contacts, particularly with the other vendors. Often vendors will make arrangements to provide services for other people operating on the street, particularly transport operators, since large numbers of people gather at the intersections of transporters' routes and at their first and last stops.

Vendors are usually alone when they invade the street. Thus, unlike the formation of settlements, an invasion contract per se does not exist here. Instead, neighboring vendors conclude partnership agreements after the street has been invaded, in order to set up informal organizations for their own defense or promote the construction of a market into which they might move.

An individual vendor who occupies a permanent location and is successful will inevitably be surrounded by other vendors. Likewise, the arrival of a new vendor in a location already occupied by other informals will serve to further consolidate their presence. In each case a critical mass essential for defining the location must be assembled. The vendors realize the flow of buyers is affected by the safety, cleanliness, quality and variety of goods offered in a location, and that their mutual interest is in maximizing this flow. Thus vendors gradually develop different types of locations on the public thoroughfare which the ILD researchers have classified as "belts" and "minimarkets."

Belts arise when vendors set up around existing markets, providing supplementary goods that expand the range of the markets. Minimarkets are created by groups of vendors who form a new nucleus of commercial activity, often in neighborhoods or informal settlements where there is a lack of the larger markets.

Often a number of vendors will share the same "pitch," or site, using it at different times of the day. For example a breakfast seller who is present early in the morning may give way to a juice seller at midmorning, who will then turn the space over to a lunch seller at midday, who is then replaced by a vendor of herbal remedies, who leaves the space to a Chinese food seller at the end of the day. These kinds of arrangements demand agreements between the users, with the benefit being that several vendors with limited services can together maximize the use of a space.

(3) Extralegal Norms for Trade

Where vendors operate from fixed locations on the public thoroughfare, the ILD has observed that an extralegal system of ordering and regulating the activities comes into play. The vendor develops a special relationship to the space he occupies in that the space remains the same and the vendor may exercise certain rights over it. The ILD calls this informal right the "special right of ownership." (More detail is provided on this extralegal norm in Module Three).

Under this extralegal norm, vendors establish a claim to a fixed location from which to sell their goods, defend this space against incursions from other vendors, and sell the rights to the location when they no longer need it.

However, this is a transitory and extralegal right, and the vendor is subject to eviction at any time, thus ruling out any long-term investment in the site. As a result, street vendors tend to continue selling from barrows, rather than from stalls built with proper building materials and equipped with water, electricity, refrigeration, storage, or other facilities which could permit the supply of a steady volume of goods.

Despite the lack of legal property rights, vendors are able to sell their special right of ownership, i.e. the right to exploit a pitch, at a price reflecting the location's value to the vendor and his customers. An ILD survey of vendor sites in 1985 found that the average price for a square meter of special right of ownership over the public thoroughfare was $164. An average pitch of 4.3 square meters sells for an average of $705, although in some vicinities they may go as high as $1,000 for three square meters.

Vendors also seek to obtain additional recognition of their special rights of ownership with the authorities, by paying what is known as an "occupancy tax", or "sisa." This tax is in effect a permit to trade on public thoroughfares within the municipality, although it confers no specific rights on the site itself. Nonetheless vendors pay the tax, and are eager to show the receipts for it, as they see it as a recognition of their rights, a situation which has apparently been accepted by residents and the authorities.

It is interesting to note that street vendors pay more for their occupancy tax than formal merchants. In 1985, a survey in one district of Lima found that while street vendors paid between $1.42 and $4.26 per square meter for their space or between 98 and 495 percent more than formally established merchants who paid an average of 72 cents for the same amount of space.

In fact, the ILD found that occupancy taxes paid by informals are a main source of income for municipal governments. In aggregate terms, income from occupancy taxes paid by street vendors in 1984 came to 70 percent more than income levied from formal traders for municipal operating permits, and to 29 percent of the total amount levied in property taxes from traders, industrialist, financiers and property owners. The occupancy tax, therefore, is the preferred means of consolidating special rights of ownership because it benefits both the street vendors and the municipal authorities. The vendors pay it because it gives them a measure of stability and security, and the authorities levy it because they obtain more income per square meter that they would if the same vendors were formally established.

(4) Self-Defense Organizations

As the vendors develop pitches which increase in value, they also seek to increase their security, which is not guaranteed by the special rights of ownership. They will often form democratic self-defense organizations which seek to protect the site from further invasions, from resistance by residents who are harmed by their activities, and from repression by the authorities. If necessary they are prepared to use force, but have developed the ability to avoid conflict by negotiating. The organizations enforce the payment of dues and adherence to set agreements regarding sales of pitches. In addition these organizations also try to maintain order and promote cleanliness at their sites, even settling disputes among members or organizing shifts for individual pitches. Many will make contacts with politicians in an attempt gain further support from the authorities.

These organizations exist at two levels, the trade union or associative level, and the federative level. The first is small-scale, usually consisting of vendors on one block or in one neighborhood, generally a democratic body calling itself an association or trade union. Since the aim of these groups is to defend their territory and define the special rights of ownership, the existence and strength of such groups is usually proportional to the amount of harassment faced at a particular site, and they tend to exist only when they have a function to fulfill.

At the federative level, the organization will cover more than one neighborhood, grouping a number of trade unions or associations under one umbrella. However, like its smaller components, this group basically responds to attacks or invitations from the state authorities and does not have an independent institutional life.

b. Informal Markets

The other major form of informal trade is that conducted by former street vendors who have decided to leave the streets.

(1) Markets & Fairgrounds

The ILD found that of the 274 informal markets in Lima, 63 percent were built by street vendors themselves, and 28 percent by formal businesses under contract to informals or for sale to them. Generally speaking, these markets are built away from the public thoroughfare, with proper building materials, cold stores, warehouses, individual stalls and sanitation.

The state has tried to provide markets as well, but has only constructed one market for every twelve built by informals in the last 20 years. Municipal governments also tried to relocate street vendors away from the thoroughfare, by developing fairgrounds in 1981. However the fairgrounds consist of simple stalls built with wood and rush mats, and do not compare to the fully equipped buildings constructed by the informals. In addition, the restrictions on the use and transfer of the stalls have further discouraged vendors from using them. As a result, while almost 39,000 former street vendors operate in informal markets, only 7,150 vendors can be found on the fairgrounds.

(2) Promotional Organizations

In order to provide the funds to build such informal markets, a number of promotional organizations have sprung up. Groups of block or neighborhood organizations will form an association or cooperative to build the market. These associations have a much more clearly defined financial and managerial role than those of the self-defense organizations, their membership is larger, and they maintain a democratic structure.

The promotional organizations are devoted to promoting the building of the market, and do not interfere with the trading of individual members. Often these groups constitute themselves as a cooperative, which allows them certain special treatment by the government.

The chief difficulties faced in building a market are acquiring the land rights, and furnishing the necessary credit. In the first case, informal markets located within the traditional city have no major problems, because the land already has services. However for markets built in informal settlements, vendors obtain only expectative property rights, equivalent to those of other residents in the same area, thus they face many of the same uncertainties regarding their ultimate right to develop a certain piece of property.

The greater problem facing those who wish to build a market is credit. Uncertainties about the title decrease the land's collateral value, while the rigidity and inaccessibility of capital markets increase the costs of credit further. As a result, many associations can only build with what the individual vendors have to contribute, which makes for a slow process which can be halted for lack of money. Often the organizations have difficulty making vendors pay their share. With cooperatives, management and administration roles are not affected by size of contribution, thus there is no incentive to make larger contributions to gain further recognition or say in the project. In fact, compliance with legal requirements for building markets has proved the biggest obstacle to vendors' access to formal trade.

D. TRANSPORT

Public transport is perhaps the area where informals have made the most visible impact in the marketplace. Not only do they provide transport to and from the country's growing informal settlements, but they provide much of the transport within the traditional city as well. According to studies made by the ILD in 1984, informals operated 91 percent of the 16,288 vehicles being used for mass transit, and 80 percent of the 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. When taxis are added, the informal presence in public transportation rises to 95 percent.

1. Types of Transport

There are two basic modes of public transport in Peru. The first is the "collectivo" or public taxi, usually a sedan with room for 5 passengers, or station wagons with room for 8 or 9. The second is the bus, ranging from minibus holding 8-11 passengers up to those which seat more than 80. The basic difference between the two modes is size of vehicles and scale of operation, not one of quality.

As with informal trade, these modes are not rigid compartments, but are stages in a process. Many informal transport operators who started with public taxis have gradually acquired minibuses.

2. Invasion

As with housing and trade, the chief method of establishing routes is done by invasion. Informal transport operators make an economic calculation to determine which routes have a potential demand, by examining the technical characteristics of the routes and the preferences of the potential users. The transporter also has to consider third parties who may be affected by the route, including other operators who may try to take over the same route, the authorities, and the citizens of communities through which the transport service may pass. Often transporters try to line up support from a government official, and will obtain hundreds of signatures from potential users, to defend their interest once the route has been invaded. This method is used both for exploiting new routes and for extending previous routes.

Transporters, like other informals, seek ways to assure the continuing and exclusive right to a route once they have invaded it. These operators negotiate with the state for recognition in the form of a concession, and then defend this concession against encroachment by other operators. Thus informal transporters have developed an extralegal relationship with the route which the ILD calls the "right to appropriate routes." (More detail on this extralegal norm can be found in Module Three).

Transporters have set up a variety of systems to ensure the inalienable right to exploit a route. These systems, organized by committees of transporters which operate a route, govern an individual operator's right to sell his share in the route, and determine to whom such a share may be transferred.

3. Informal Transporters' Organization

As routes and rights to them increase in value, the informal operators' incentive to organize, negotiate and deal with legal institutions increases. These groupings occur at two levels, committees of informal transport operators operating the same route, and different committees grouped together into unions, and later, federations.

The committees perform a number of tasks, including operating the route in an orderly manner, negotiating with authorities, and providing enough vehicles on a certain route to keep out invaders. These groups may also organize communal funds to provide insurance coverage, or limited forms of credit for members.

Unions and federations deal with larger issues related to state imposition of controls on the transport sector, most notably fare controls. These unions ally themselves with political organizations, in order to increase their leverage over the central government, although their alliances have more to do with effectiveness than with ideology. On numerous occasions in the past 20 years, these federations, through strikes and other actions, managed to win temporary cancellation of tax debts, exemption from certain taxes the right to import tax-free spare parts, and have successfully lobbied to decrease penalties levied on transporters for traffic violators.

E. MANUFACTURING

Informal industry was the most difficult sector to quantify, because it operates "underground." Nonetheless, using its methodology, the ILD has determined that informals are working in areas ranging from mining equipment, bicycles and furniture, to shoes, textiles, preserved meat and fruits.

Because of the clandestine nature of informal manufacturing, the ILD used indirect methods to determine the magnitude of activity. Using statistics from INE, the National Institute of Statistics, the ILD found a discrepancy in the ratio of inputs, particularly cotton and leather, to outputs in official figures on the manufacturing sector. This was determined to be a result of those informal manufacturers whose inputs were bought in the formal market but who produced and sold on the informal market. Using an estimation of 1-4 workers as the average size of an informal manufacturing enterprise, and the projected production figures for the "missing" outputs, the ILD was able to calculate what portion of manufacturing is done by the informal sector.

The ILD estimated that informal manufacturing accounts for 60 percent of the production of garments and furniture, and 35 percent of shoe production. In all, informal industries make up 52 percent of industrial establishments, employ 34.2 percent of industrial workers and generate 15 percent of the value added in the whole sector.

The chief characteristic of informal manufacturing is the small size of the workshops. In order to avoid detection, business owners are obliged to keep operations small or to disperse units of production in several smaller workshops. The inability to procure credit and the fear of seizure of equipment limit the possibilities for growth. As such, it is virtually impossible to find an informal industry of any great size, or one that uses more than the simplest technology or production methods.

IV. SIMULATIONS TO DETERMINE LEGAL CONSTRAINTS

One of the ILD's key research methods of determining the legal and administrative constraints that face private entrepreneurs and the costs entailed is the use of simulations.

A. BUSINESS REGISTRATION

1. The Costs of Access to Industry (289 Days)

In the summer of 1983, a team of ILD researchers conducted the ILD's first simulation, designed to see how long it takes to set up a legally registered business. One lawyer and four assistants set out to establish a small garment factory on the outskirts of Lima, in compliance with all the bureaucratic procedures required for legally establishing a business.

The team simulated the creation of a business with a single proprietor, without incorporating the enterprise, which would have been a more complicated procedure. The ILD rented space for the factory, installed sewing and knitting machines and other implements, and then sent the four assistants, with a stop watch, to each office in the state bureaucracy necessary to register the workshop. The simulation was set up as if the researchers came into the city each day from the informal settlement of El Salvador,

to visit the different administrative centers where the procedures were carried out. The team went from office to office, took detailed notes, timed the procedures, and gathered all the required documents.

The team decided to handle all the necessary red tape without relying on go-betweens, and if possible, without paying bribes. During the simulation, team members were asked for bribes ten times, even though they had complied with all the necessary legal requirements. In two situations they were obliged to pay the bribes to continue the exercise, while in the other eight they were able avoid paying, albeit with great difficulty.

The results of the simulation showed that the average person interested in setting up a small industry must spend **289 days** on bureaucratic procedures to fulfill eleven requirements for setting up a small industry (See **Figure 1**). The ILD also calculated the cost of complying with the bureaucracy. The end cost, including the two bribes, 11 permits, and the ten-month loss in income while waiting for approval, came to $1,231, or thirty-two times Peru's monthly minimum wage.

For a comparison, the ILD sent a researcher to Tampa, Florida to set up a similar operation, where the entire process took 3-1/2 hours. A third test was conducted in New York, where the operation took four hours.

2. The Costs of Access to Trade

The ILD chose to look at the cost of access to formal trade, given the large numbers of Peruvians who trade informally on the street or in markets. In this area the ILD studied two possibilities: opening a store and building a market or shopping center. In the first case, researchers used the same method that had been followed with the sewing establishment. Under the second simulation the ILD researched existing legislation and examined actual markets or shopping centers built by street vendors.

a. Store (43 days)

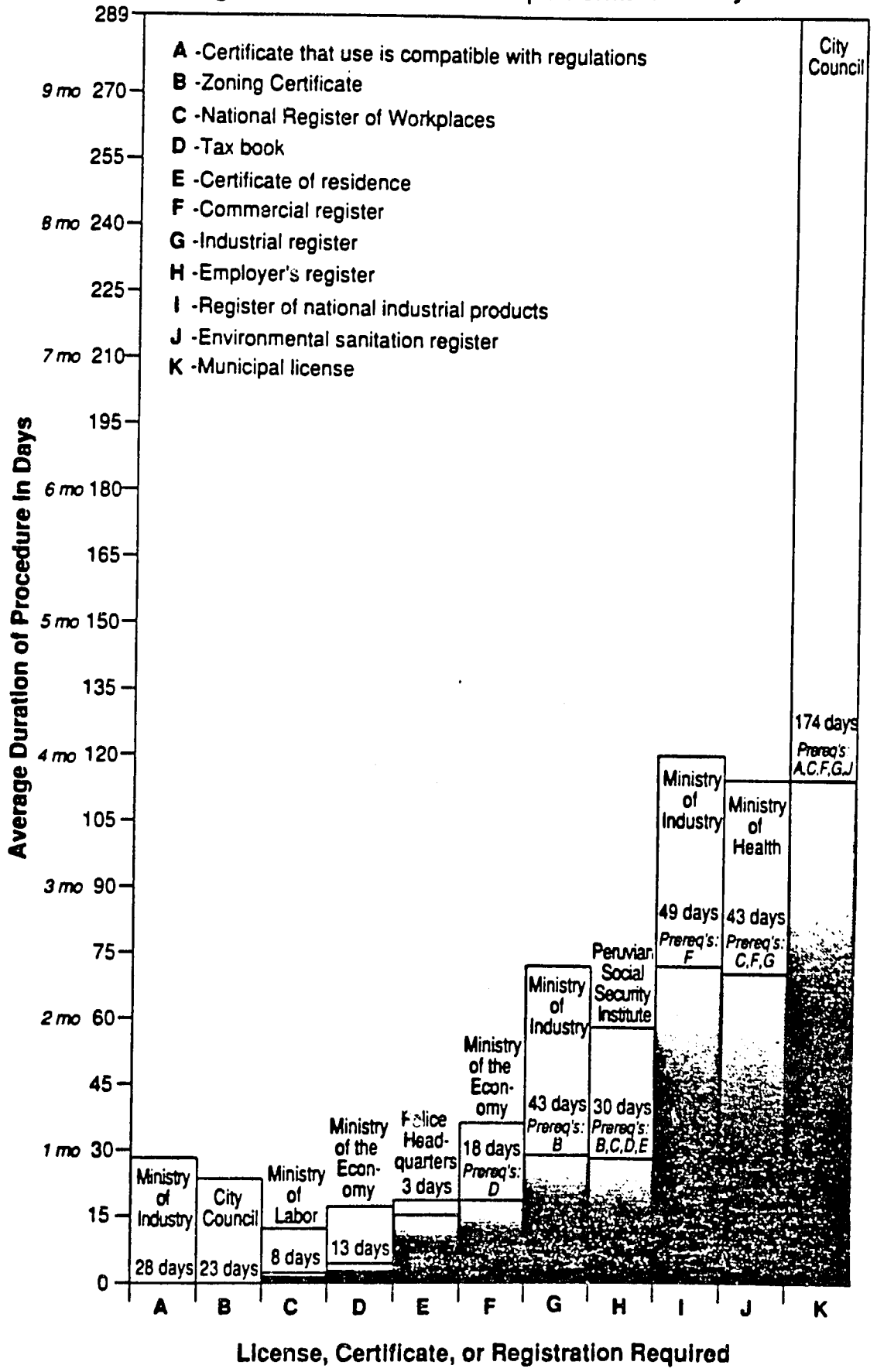
The researchers chose the neighborhood of San Juan de Miraflores, a new, prosperous commercial area, to set up their store. The simulation was conducted in the same way as for the sewing industry, i.e., complying with all requirements, using no go-betweens, paying no bribes. The simulation showed that to open a small store a Peruvian entrepreneur must comply with bureaucratic procedures involving three different government departments, in a process that takes **43 days** and costs $590.56, or 15 times the monthly minimum wage at the time of the study.

b. Market (17 years)

To look at the costs of building a market, the ILD studied five cases in which vendors had organized to build their own markets, in a sample covering the city's main commercial areas. The exercise showed that it took an average of **17 years** from the formation of a minimarket until the full market comes into operation. Deducting the amount of time it takes for vendors to organize themselves, the waiting period is at least 14-1/2 years to have a fully operating market.

142

Figure 1: Procedures to Set Up a Formal Industry



143

3. The Costs of Access to Transport

In the case of transport, the issue of costs of access is much simpler than in the other sectors, because there simply is no legal access to this activity. No group of transporters has the right to establish itself and request a route, only the state has the power to award rights to routes and to decide which routes need new or extended transport services. Only if authorized transport operators are unable to offer their services can the authorities grant new operating rights to third parties.

To determine the costs of access in this sector, the ILD interviewed Ministry of Transport and Communications officials to learn what a hypothetical procedure for gaining access to transport activities might entail. There were two possibilities, both leading in theory to the granting of a right to a route.

First, a group of people might decide to form a committee informally and request a minibus concession. This hypothetical procedure would take approximately 26 months, involving 4 major bureaucratic steps. Second, a group of people might decide to incorporate themselves formally and request a bus route concession. This hypothetical procedure would take 27 months and would entail five major bureaucratic steps.

B. LAND ADJUDICATION AND DEVELOPMENT FOR HOUSING

The ILD also chose to look at the costs of access to housing. Here it was not possible to use a simple simulation because it would have been necessary to set up an association or cooperative, and commit hundreds of people to the activity for a long period of time.

Instead the ILD used indirect sources, by examining the laws, and by examining actual administrative cases. By examining the laws, the researchers determined the characteristics of the various procedures; and by studying actual cases, they determined the average duration of the procedures. The ILD chose to look at the only three cases where requests for land had actually been settled by the government since 1981, when a law regarding settlement of such claims was enacted. Interestingly enough, during the time the government had settled those three claims, hundreds of illegal invasions of land by groups of informals had taken place.

The ILD determined that if a group of families wishes to legally acquire urban land for housing, they must request adjudication of a piece of state wasteland, present a plan for developing the land, and receive a building permit and certification that the buildings conform to the approved plans. Based on the ILD's calculations, the entire process takes an average of 83 **months**, or six years and 11 months, if all the established requirements are met.

1. Request for Adjudication (43 months)

If a Peruvian citizen cannot afford to buy an urbanized lot and wishes to acquire legal ownership of his land and home, he or she must request adjudication of the land. According to the ILD's calculations, this procedure takes **43 months** (three years and seven months) and involves up to six different state departments, including the presidency of the Republic. In all, 48 government offices are involved and 207 bureaucratic steps must be followed, each of which takes about one working week.

144

In addition, those who acquire state land through this procedure acquire a defective title, in that they are not allowed to sell or encumber the land without permission from the provincial government.

Based on the amount of time, information and resources needed to carry out this process, the ILD calculated that for a hypothetical housing association with 244 members, the total cost of the adjudication procedure would be $526,019. Each member would have to pay $2,156, or four years and eight months of salary at the minimum wage level, to legally acquire land for housing.

2. Approval for Land Development (28 months)

Once land has been acquired, it must be developed, including the provision of public utilities. This process has strict guidelines regarding zoning regulations, minimum quality standards and maximum permissible density for basic services, all of which must be taken into account when preparing a development plan for the land. The process involves three different stages, all of which must be coordinated with the Lima City Council: approval of preliminary studies for a project, approval of the project and execution of the project, including inspection of the work done. The ILD found that it takes an average of 28 months to complete this process.

3. Building Permits (12 months)

Once the land has been acquired and developed, building permits must be obtained prior to construction. Once the construction is complete, certification that the construction conforms to earlier plans is required. The ILD found that it takes about 12 months to obtain these two documents from the City Council.

From all the simulations run in different sectors, the ILD found the costs of access to formality to be the most disproportionate in the case of housing—a total of 83 months is required to obtain land and build a house. In effect, the bureaucracy makes the access to formality so expensive that for people of simple means the only possible course is informal urbanization.

V. CONCLUSIONS FROM THE ILD'S RESEARCH

> "[The ILD] discovered that informality is not the best of all possible worlds, that it involves tremendous costs, that people try to offset these costs in all kinds of novel but inadequate ways, that lawbreaking is not, on the balance, desireable, and that the apparent chaos, waste of resources, invasions, and everyday courage are the informals' desperate and enterprising attempts to build an alternative system to the one that has denied them its protection."
>
> Hernando de Soto, *The Other Path*

145

A. INEFFICIENT LEGAL, POLITICAL AND ADMINISTRATIVE INSTITUTIONS

Nine years of research by the ILD have shown that the inefficiency of Peru's legal and administrative institutions has much to do with why informals choose to become informal. The costs which are imposed by these institutions to enter the formal sector, and the costs of remaining in it, are prohibitively high for most Peruvians, leading many of them to conduct their activities partially or wholly in the informal sector.

The lack of public participation in rulemaking and of government accountability to the public, leading to a lack of adequate legal mechanisms and overabundance of bureaucratic red tape, has served to block economic growth, and to drive entrepreneurial activity into the informal sector, and has led even formal established businesses to seek advancement by extralegal means. As a result, the country's legal and administrative institutions have lost their social relevance. In addition, public disenchantment and disenfranchisement, coupled with the country's economic problems, have led some Peruvians to embrace radical or violent means to oppose the central government.

B. INSTITUTIONS AND THEIR RELATION TO TRANSACTION COSTS

Implicit in the ILD's analysis of economic activity is the role of rules and institutions in determining transaction costs in a developing country.

Transaction costs (sometimes known as the "cost of doing business") are those costs resulting from efforts to negotiate and implement agreements required for the exchange of goods and services and the combination of human and material resources needed to produce them. Transaction costs are caused by the degree of complexity of the transaction, by the difficulty of obtaining cooperation from others to reach a common goal, and by the costs and quality of services provided by the state in order to facilitate the negotiation and implementation of agreements.

These costs must be added to production costs to determine the true total cost of undertaking a certain activity. Traditional economic models have assumed that the costs of an exchange are zero, or include only visible transaction costs, such as tariffs, quotas and freight charges. However, a number of economists (e.g. Douglass North, Ronald Coase), have argued that transaction costs are actually a major part of the cost of operation of a business or an economy (up to 45 percent of U.S. GNP in 1970). Where property rights (e.g., the right to use, to derive income from or to exclude others) are poorly defined, or poorly enforced, transactions involving the property become more expensive.

Building on this theory, the ILD has pioneered the use of empirical research to measure those transaction costs which result from legal and administrative constraints posed by institutions. The results of the ILD's research have shown that those institutions, and their shortcomings, impose heavy transaction costs on both the formal and informal sector.

146

C. THE COSTS OF FORMALITY AND INFORMALITY

The ILD's conclusions, as presented in *The Other Path*, show that law plays a major role in determining the efficiency of the economic activities it is intended to regulate. Where legal and administrative institutions facilitate an efficient exchange of goods and services, transaction costs are low and economic growth is possible. To be facilitative, institutions must have affordable (in terms of time and money) regulations, clearly defined rights, and offer adequate protection of those rights. Where, through lack of the above, institutions impede efficient exchanges, transaction costs are high and growth potential is diminished. Thus the ILD refers to "good laws" and "bad laws": a law is "good" if it guarantees and promotes economic efficiency and "bad" if it impedes or disrupts it. The unnecessary costs of informality and of formality all stem from the existence of bad law; or from the absence of good law.

1. The Costs of Formality

In a formal economic activity, people evaluate their relationship with that activity at two moments in time-when they enter it and when they decide to remain in it. To define these two moments, the ILD coined two corresponding concepts, "the cost of access" to the activity and "the cost of remaining" in it. These two concepts are used to examine all the requirements a citizen must meet in order to engage in a specific economic activity, and later, all the requirements necessary to preserve that legality.

The ILD determined the **costs of access** to the formal sector through the simulations described above, i.e., by examining all the requirements necessary to legally engage in an economic activity, and by determining the costs in time and money to attain fully legal status. As has been demonstrated, the ILD found that the costs of access to the formal sector are prohibitively high for many Peruvians.

The **costs of remaining formal** are those costs incurred by established businesses which, in order to stay legal, must comply with a multitude of legal restrictions and regulations. This refers to costs directly imposed by the law—taxes, compliance with bureaucratic procedures, obligations to administer personnel in a certain way, and payment of higher rates for public utilities, as well as indirect costs imposed by legal institutions as a whole. These indirect costs include the instability of the legal system, insecurity of property rights, and the inefficiency of the judiciary in settling disputes or collecting debts.

Example: The Costs of Remaining Formal

The ILD conducted a survey of 50 small formal industrial firms, to determine the direct costs incurred by the firms in complying with the law. The researchers found that remaining formal costs a firm on an average 347.7 percent of its after tax profits and 11.3 percent of its production costs. For every $100 that a small industrial firm must pay in order to remain legal, $22 goes to taxes, $5 to utilities, and $73 to legal costs. These legal costs are the time and money necessary to comply with bureaucratic procedures. In another survey of 37 legally established companies, the ILD found that companies spent approximately 40 percent of all their administrative employees' working hours complying with bureaucratic procedures.

As has been demonstrated above, the costs of access are so high that many Peruvians are simply unable to establish their activity in the formal sector. Likewise, many of those who are already in the formal sector find it difficult to meet the legal requirements to remain legitimate, and ultimately move their activities, partially or completely, to the informal sector. This move is made "easier" by the fact that the formal sector, with its inadequate institutions, provides few benefits to its members to outweigh the costs it imposes.

2. The Costs of Informality

Although, the costs of access to or remaining in a formal activity can be extensive, the costs of informality are high as well. As was seen in the sections on housing, trade, and transport, informals have had to establish an extralegal system to make up for what they have lost by being outside of or in defiance of the law. However, this extralegal system cannot totally compensate for the absence of an effective state-maintained legal framework. Informals' illegality also imposes certain costs.

a. The Costs of the Absence of Good (Facilitative) Law

Because informals suffer from the absence of a legal system that guarantees and promotes their economic efficiency, their transaction costs are high and their courses of action limited due to the climate of uncertainty that exists in the informal sector.

The most significant cost of the absence of good laws is the **lack of secure, reliable property rights**. Based on its studies of the informal sector, the ILD reached three conclusions regarding the lack of property rights. First, informals' incentives to invest are greatly reduced as long as their rights to land, housing and equipment are not enforceable. Secondly, informals cannot transfer their property easily, using it for more valuable purposes or as collateral. Thus productivity is limited as a result of informals' inability to mobilize their property as a factor of production. Thirdly, informals incur substantial costs in defending their possessions and satisfying the need for public property by establishing and operating community organizations. These organizations demand a large investment of time and other resources, yet are unable to force delinquent members to contribute to their operating costs.

Because their activities are extralegal, informals also suffer from an **inability to use the formal contract system**. Most of the contracts organizing and transferring property rights are not defensible in the formal legal system. The exceptional difficulties in enforcing contracts mean informals are discouraged from entering into long-term commitments, or from investing in jointly-owned equipment.

b. The Costs of Illegality

The most common costs of illegality are the costs of avoiding penalties, the high cost of credit, the effects of inflation, and the consequences of evading taxes and labor laws. These costs demonstrate that the apparent benefits of evading the law do not yield greater returns than legal business does.

- **The costs of avoiding penalties**—Informal businesses devote a tremendous amount of effort to avoiding detection and punishment by the authorities. Informals constantly run the risk of being penalized for not having obtained permits, paid taxes, or applied for authorizations required by law. The ILD found through interviews that this was a major concern of informal business owners.

  In order to avoid detection, informals must rely on a variety of strategies. Informal businesses, particularly informal industries, will:

  - Disperse employees among a number of smaller and less visible workplaces. The need to keep the business small or spread out also prevents businesses from achieving more efficient scales of production.

  - Not advertise their goods or services. This lack of advertising can inhibit the growth of business, as the owner is forced to rely on word of mouth or reputation. (The U.S. Small Business Administration estimates that two-thirds of all customers in the United States are brought in by signs displayed outside shops or factories.

  - Not enter legally established markets that are barred to them, e.g. stock markets and trade fairs. This also prevents them from benefitting from the use of shares, letters of credit, etc.

  - Bribe government officials. While formal small businesses said they paid no more than one percent of their gross income for bribes and commissions, informal businesses spend between 10 and 15 percent of their gross income in order to avoid penalties. Given the large percentage of businesses working in the informal sector, this systematic corruption represents not only a large expense for many small businesses, but also undermines the principle of authority in the country as a whole.

- **Higher cost of credit**—Informals pay higher rates for credit than formals, because usually they are unable to obtain credit from banks and other sources of formal credit. Interest rates on the informal market in June 1985 were as much as 22 percent a month in Lima, compared to the maximum of 4.9 percent set by formal banks. Informals usually get their money through intermediaries who have access to formal credit and then turn around and offer it higher rates to informals.

- **More greatly effected by inflation**—Because informals generally tend to keep more cash in hand than formals, informals also bear the cost of inflation, as those who keep their money in cash are hurt the most by rising prices and declining purchasing power.

- **The costs of evading taxes and labor laws**—a final major difference between formals and informals is that the latter generally do not pay direct taxes or comply with labor laws. Informals generally pay lower wages than the official minimum, which assures them a ready supply of unskilled workers, however it prevents them from using anything but methods with low technology and productivity.

In summary, the ILD's work in defining, observing and measuring the costs of complying with the law, or the costs derived from the lack of a law, has led the Institute to the conclusion that a system which drives people towards the informal sector imposes great costs not only on those in the informal sector, but also on the formal sector and on society as a whole.

D. NATIONAL ECONOMIC CONSEQUENCES

Examining the economic consequences of the combined costs of formality and informality leads to the following observations about the effects of a legal and institutional framework that encourages such a division in the economy.

- **Declining productivity**—Generally speaking, the lack of good institutions and facilitative law, and a quagmire of excessive government regulations result in a waste of resources, both in terms of formal and informal activities. Formal businesses must devote considerable time to complying with regulations, while informal establishments face high costs in avoiding detection. In addition the many restrictions affect the flexibility of decision-making and cause resources to be used inefficiently. As a result, productivity declines. Two factors that have a crucial effect on productivity are level of investment and technical progress.

  - **Reduced investment**—The ILD has concluded that there is a lower level of investment in Peru's economy than if the legal system functioned efficiently. Informal businesses use more labor-intensive technology, which significantly reduces capital investment, particularly since business overall in the country is moving towards informality. Second, in view of the difficulties which informals face in enforcing contracts, and the high rate of return which financiers request of informal investors, there is little long-term investment in production.

  - **Limited technological progress**—The existence of informal activities undermines technological progress for several reasons, including the small size of the businesses, their lower level of interaction in production, and their inability to protect technical innovation. Fear of detection, the absence of property rights, and the difficulty of enforcing contracts all lead to the small size of businesses, with a resulting loss in innovative, productive activity.

- **Inefficient tax system**—The current tax system is structured so that the main burden rests on those who are still operating formally, primarily those small to medium-sized firms which do not benefit from the tax exemptions accorded major corporations. Meanwhile, the state squanders vast resources on detecting evasion, and unnecessary distortions occur throughout the economy. As the government increases taxes to increase revenue, it has the effect of increasing informality, and discouraging those businesses which stay in the formal sector from expanding their activities.

- **Increased utility rates**—The same phenomenon occurs with public utility rates. Informals who tap the water and electricity supplies illegally drive up rates for formal activities which use the utilities.

Difficulties in forming macroeconomic policy—The government makes macroeconomic decisions—relating to the size of the deficit or the rate of growth of the money supply—based on their measurements of the performance of the economy. Although policy makers are aware of the informal sector, its size and growth are difficult to measure or predict, thus introducing a greater element of uncertainty or speculation about the economy in the design of macroeconomic policies.

E. THE PARALLELS WITH MERCANTILISM

The ILD research indicates that Latin American law discourages entrepreneurship and does not allow for popular participation in government. There is a parallel between modern-day Latin America and European mercantilism of the 15th to 19th centuries. Mercantilist states in Europe, like Peru today, granted privileges to favored producers and consumers by means of regulations, subsidies, taxes, and licenses. In Europe 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 left or right, civilian or military, the elites rule in the same way, through closed, special interest legislating.

Some of the areas where parallels can be drawn between European mercantilism and Peru are:

- Access to enterprise is reserved for the chosen few, those with political or other connections to those in power.
- Excessive legal regulation, intended to limit competition with certain monopolies or privileged industries.
- The growth of public and private bureaucracies, which see their raison d'etre as the redistribution of wealth according to their own interests, rather than encouraging an open competitive market economy.
- Powerful businessmen in Europe, as in Peru today, organized themselves into redistributive combines which created a pseudo-bureaucracy of lawyers, accountants and other "public relation" functionaries to petition government in their interest. One type of combine was made up of guilds—associations of producers which today might be regarded as cartels. Their aim was to secure favorable legislation for themselves while limiting access of newcomers to the marketplace.

VI. NEW PROGRAMS OF ECONOMIC RESEARCH

Building on its existing work, the ILD is currently conducting economic research in two new priority areas; capital markets and foreign trade. The interest in these two areas has grown out of the implementation of the ILD's institutional reform efforts: the Popular Mortgage and Administrative Simplification programs. (These programs are described in detail in Module Three).

A. Capital Markets

Existing government intervention in the capital market, through interest regulations and direct state control of the supply of credit, distorts the functioning of the market, preventing the efficient flow of resources toward the best incentives. The ILD is currently examining the excessive transaction costs induced by credit market regulation, through analysis on the cost of access to credit within the formal and informal capital markets.

The study is being carried out through surveys and interviews with formal and informal entrepreneurs, bankers and other important actors in the credit market, and includes the following areas of research:

> **In the formal capital market**: description of the structure and size of the formal credit markets; identification of legal rules which regulate access to credit; description of steps with which citizens must comply to legally obtain credit; field studies to estimate the economic costs of complying with the identified regulations, including the costs of filling out forms, bribes, and opportunity cost of time wasted; and estimation of the legal and institutional costs as a percentage of the amount borrowed, in order to compare it with official interest.
>
> **In the informal capital market**: the structure and size of the informal capital market, mechanisms by which money is lent; and conditions for lending (interest rates, payback periods and guarantees required); and estimation of transaction costs in the informal credit markets, as a percentage of official rates.

The results of the study will be used to determine potential administrative reforms that would increase informals' access to the formal credit market. In particular, results of the study will be used to design institutional reforms which could address the increased demand for credit among informals who have benefitted from the Popular Mortgage program.

Under this ILD-initiated effort, informals will be allowed to register their property in an official Registry of Possession, obtain a Popular Mortgage, and apply for Credit Insurance. As informals complete this process, the demand for credit within the informal sector is expected to increase by 75 percent.

B. Foreign Trade

The ILD also plans to conduct a study of foreign trade, using a similar methodology to measure the costs of legal and institutional constraints placed on people involved in import and export activities. Particular emphasis will be placed on determining those regulations or procedures which could be modified or eliminated under terms of the new Administrative Simplification Program to facilitate foreign trade. This ILD-sponsored institutional reform initiative seeks to eliminate unnecessary and costly bureaucracy, and to ensure public participation in the rulemaking process. The ILD also will examine carefully the role of the Institute for Foreign Trade (ICE - Instituto del Comercio Externo) which has been severely criticized by exporters.

GLOSSARY

Bad Law	In ILD terms, a law which impedes or disrupts economic efficiency, e.g. excessive bureaucratic procedures for registering a business, gaining title to land, etc. The opposite of "Good Law."
Collectivo	Informal public taxi, usually a sedan or station wagon with room for up to eight or nine passengers.
Cost of Access (or Entry)	The cost in money and time for a citizen to meet all requirements necessary to obtain the right to legally engage in an economic activity, including the preparation of documents, payment of fees, acquisition of permits, etc.
Cost of Remaining Formal	The cost in money and time for a citizen legally engaged in an economic activity to meet all requirements necessary to remain legal, including observance of regulations, payment of taxes or fees, etc.
Cost of Formality	The cost in time and money for a citizen to meet all requirements to legally enter and remain engaged in an economic activity.
Cost of Informality	The cost in time and money for a citizen to illegally enter and remain engaged in an economic activity in the informal sector. This includes costs incurred due to the absence of facilitative law, and to the hazards of illegality itself (e.g. penalties).
Delphi Method	Survey method which uses a panel of experts to interview and evaluate information given by key informants. These informants usually have special access to information sought, although they may not be experts on the subject.
Empirical Method	Research method that relies solely on experimentation, observation and experience, rather than on theory.
Excessive Cost	The difference between the actual cost and the minimum cost required to reach a given objective.
Expectative Property Right	The provisional property right established by an invasion, which serves in lieu of official property rights. This extralegal norm is based on the informal settlers' assumption that they eventually will be granted legal title to the land.

Extralegal Norms	A spontaneously generated body of rules commonly understood and accepted by those affected, but which normally has no bearing or standing in official legal circumstances.
Facilitative Law	A more formal term for "good law" (see below), i.e., a law which guarantees and promotes economic efficiency
Good Law	In ILD terms, a law which guarantees and promotes economic efficiency, e.g., property rights, contracts, etc. Also related to "Facilitative Law." The opposite of "Bad Law."
Invasion	A situation where informals illegally "invade" or occupy state or private land, for the purposes of building housing, claiming a location for street vending, or controlling a route for transport. These invasions can be "gradual"; or "violent", i.e. sudden, unexpected, and occasionally involving the use of force to defend a location once it is occupied.
Invasion contract	Agreement reached by informal invaders regarding the establishment, demarcation and distribution of a settlement; and the functions and responsibilities of the informal organization which will provide leadership, maintain law and order and defend its residents. An extralegal norm developed by informals.
Itinerants	Street vendors with no fixed locations, also known as "ambulantes" in Spanish.
Long Frontier	The gray zone that exists between the formal and informal sectors, where entrepreneurs may move from informal to formal activities, or vice versa, or operate in both sectors simultaneously.
Mercantilism	The economic doctrine prevalent in Europe with the decline of feudalism in the fifteenth century and continuing through the eighteenth century, that protected local industries through tariffs on imports and the creation of monopolies; those parties with access to power obtained important privileges. Parallels to European mercantilism exist in current economic doctrines practiced in Latin American countries and elsewhere in the Third World.
Monetary Method	A macroeconomic method of analyzing economic activity through examination of the amount of currency in circulation in the system relative to currency deposited in banks.
Occupancy Tax "Sisa"	A permit to trade on public thoroughfares, issued by municipal governments. Informal street vendors use these permits to strengthen their claim to fixed locations, although the permits confer no specific rights to the site itself.

Right to Appropriate Routes	An extralegal norm whereby informal transporters try to establish exclusive rights to operate along specific routes. Transport associations may buy and sell shares of a concession to individual drivers, and negotiate with the government to obtain de facto recognition of their concession.
Special Right of Ownership	An extralegal norm developed by informal street vendors to establish claim to their fixed locations, defend the space against incursion by others, and sell the rights to the space when they no longer need it.
Transaction Costs	The costs arising from efforts to negotiate and implement agreements required for the exchange of goods and the combination of material and human goods needed to produce them. Also referred to as "the cost of doing business."

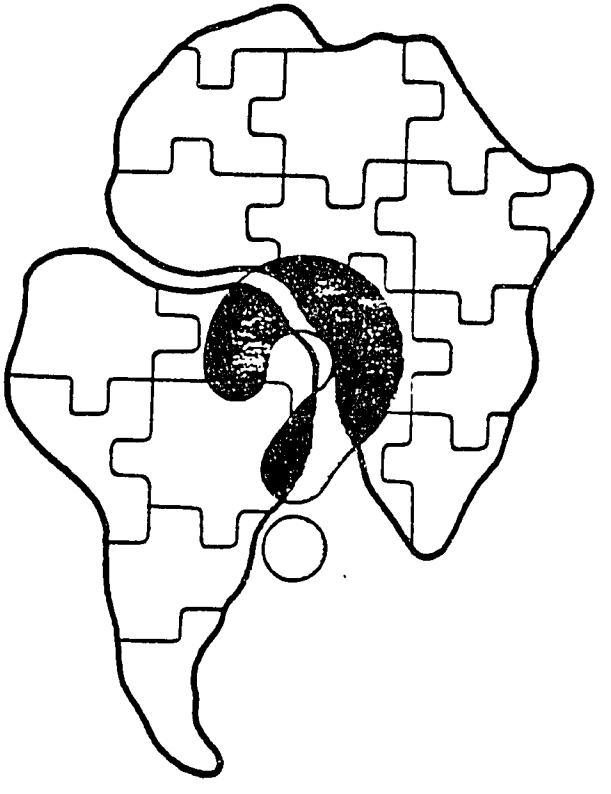
- SECTION 3 -

ILD TRAINING PROGRAMS: MODULE 3

TRAINING PROGRAM FOR AFRICAN RESEARCHERS
IN ECONOMIC ANALYSIS OF INFORMALITY
AND INSTITUTIONAL REFORM

MODULE THREE:

INSTITUTIONAL REFORM



November 27, 1989 – December 5, 1989

Sponsored By:

Institute for Liberty and Democracy
Lima, Peru

Agency for International Development
Bureau for Africa, Office of Technical Resources

MODULE THREE

INSTITUTIONAL REFORM

TABLE OF CONTENTS

I. INTRODUCTION 1

II. RULEMAKING 1

A. LESSONS FROM BAD LAWS IN PERU 1

B. LESSONS FROM EXTRALEGAL NORMS IN PERU 3

1. Informal Housing 3
2. Informal Trade 4
3. Informal Transport 5

C. LESSONS FROM LAWS IN DEVELOPED NATIONS 6

1. Democratic Rulemaking 6
2. Deregulation and Decentralization 6
3. Simplified Administrative Procedures 7
4. Public Information 7
5. Free Press 8
6. Checks and Balances 8
7. Judicial System 8
8. Public Defense 9

III. INSTITUTIONAL REFORM PROGRAMS AT THE ILD 9

A. PROCESS 9

B. COST-BENEFIT ANALYSIS 11

1. The Concept 11
2. Cost-Benefit Analysis of Municipal Ordinance 002 12

C. POPULAR MORTGAGE CASE STUDY 14

1. Description of the Program 14
2. Benefits of the Program 15

D. ADMINISTRATIVE SIMPLIFICATION CASE STUDY 15

1. Program Description 16
2. Public Feedback: The Citizens' Councils 16
3. Bureaucratic Accountability: The Administrative Simplification Tribunal 17

4. Support from the ILD 18

a. Administration 18
b. Public Affairs 18
c. Technical Expertise 18
d. Political Affairs 18

5. Anticipated Results 18
6. Method of Evaluation 19
7. An Exercise in Democracy 19

IV. NEW PROJECTS 21

A. DEMOCRATIC RULEMAKING 21
B. AGRARIAN LAND TITLING 21

1. The "Parceleros" 21
2. The Andean or Peasant Communities 22

V. GLOBAL PERSPECTIVE: THE DEBT CRISIS AND STRUCTURAL ADJUSTMENT 22

GLOSSARY 26

NOTES 29

MODULE THREE

INSTITUTIONAL REFORM

I. INTRODUCTION

The ILD's research to date challenges the earlier beliefs that much of the poverty in Latin America (and indeed throughout the developing world) stems from an incompatibility between the local culture and successful private sector development characteristic of Western developed nations. The ILD's research and the success of its reform proposals demonstrate the extent to which the informal sector represents an indigenous entrepreneurial response to the problems of a legal and institutional system poorly adapted to the needs of the people.

The failure of private enterprise to produce growth in Latin America is not the result of market economies which cannot function in that part of the world, but the result of legal institutions that control private economic activity are mercantilistic and stifling.

Mercantilism centralizes economic and political decision-making in a small elite. In much of the developing world today, whether the ideology is of the right or of the left, civilian or military, the elite rules in the same way: through special-interest rulemaking that does not respond to broad economic demands.

In Europe during the last two centuries, both Western and Eastern systems moved away, in different ways, from the unworkable contradictions of mercantilism. While the transition from mercantilism to communism is well documented and easily understood, the same is not true of the transition to Western-style democracy, which remains uncharted.

To chart the course, it is necessary to identify the needs and obstacles of the entrepreneurial majority, the informals, and to provide the institutional reforms with which they can identify and which will allow them to prosper.

Building on the measurement of the scope of and constraints to economic activity described in Module Two, the ILD has undertaken an analysis of possible institutional reforms to achieve economic growth. This is a three-step process: first, to analyze the extent of the failure of the legal institutions in Peru to respond to the needs of the informal majority (bad laws in Peru); second, to determine how the extralegal system which the informals have created helps to offset that failure (extralegal norms in Peru) and finally to examine the institutions created by other countries which successfully confront problems similar to those found in Peru (laws from developed countries). The general lessons learned over time from the ILD's analyses of each of these areas are described below.

II. RULEMAKING

A. LESSONS FROM BAD LAWS IN PERU

Peru's legal institutions are clearly mercantilistic. *The Other Path* describes the situation as follows: "popular access to private enterprise is difficult or impossible for the popular classes, the legal system is excessive and obstructive, there are massive public and private

bureaucracies, redistributive combines have a powerful influence on lawmaking, and the state intervenes in all areas of activity."

The ILD recognizes that the mercantilist tradition was established by the colonial powers. *The Other Path* quotes Donald Dozer of the University of Florida on this subject:

> "Acceptance of the supreme and overriding power of the state ... is the inheritance of Latin America. The Roman law and its derivative, the Napoleonic Code, which form the basis for the legal system of Latin America, exalt the authority of the state. Despite the successful resistance of Latin Americans to Spain, Portugal and France in their wars of independence, the tradition of government absolutism and centralized authority of the state as the decisive factor in human life ... casts its long shadows over modern Latin America - not only as an idea but also as a basis for action."

With its huge apparatus, the state has every means of controlling private enterprise and private property: it can expropriate private resources, has unrestricted rights over any property not assigned to private individuals, centrally controls import and export tariffs and licenses, currency exchange and prices and most savings and credit. It also controls allocation of subsidies and buying and selling by state monopolies. Successful businesses are forced to devote resources to infiltrating such an all-powerful bureaucracy in order to protect their interests.

The ILD proposes to do away with the bad laws of mercantilism which seek to regulate every issue and to replace them with good, efficient laws which produce the desired effects, i.e. the development of a modern economy open to all sectors of the population.

On inquiring into how "rules" are created in Peru, the ILD discovered that, to a great degree, they are dictated without any procedures to ensure oversight by or accountability to the electorate. There is no "rulemaking," no "comment and notice" periods, no public consultations through hearings, no cost-benefit analyses of the foreseeable consequences of the approved norm, and there is no way to make the state accountable for the norms once they have been enacted.

From 1947 to 1985, the Executive Branch enacted yearly 99% of the Peruvian rules and regulations while Congress approved only 1%. Therefore, on the average, 99% of the 27,400 rules and regulations issued annually were approved without the most minimum "rulemaking" procedures to ensure participation or oversight by either the elected officials or the citizenry.

In Peru there is no system of checks and balances within government and no accountability. As a result, rules are made without any consideration for the costs imposed on the rest of society and respond to narrow political interests rather than broader social and economic concerns.

The President of Peru has extremely broad powers, including most legislative and regulatory functions. Congress can and does frequently delegate legislative powers to the President. The President can enact extraordinary economic and financial measures, provided he simply informs Congress. The President can fix tariffs, exchange rates and interest rates and can control state purchases and works. Local governments have very limited regulating authority.

The judiciary, which should act as an independent check on the exercise of executive and legislative power, in practice is subservient to the executive. Not only does the executive appoint the judges, but it can dismiss them as well, as occurred recently when the Supreme Court, backing President Garcia's position, dismissed a judge who ruled against the bank nationalization.

The Tribunal for Constitutional Guarantees is another example of the lack of an independent judiciary. While its function is to ensure that the government adheres to the Constitution, in practice it is toothless. While its members are technically appointed by the Executive, Parliament and the Supreme Court, in practice they are appointed by the party in power, since it controls all three branches.

In order to move from a mercantilistic state to a modern democracy and market economy system, monopolistic decision-making must be abolished. Modernization means not only getting rid of bad laws, but also creating the basic institutions through which laws are made responsive to all on a continuing basis.

B. LESSONS FROM EXTRALEGAL NORMS IN PERU

The first part of *The Other Path* describes how informals, rather than surrender to anarchy, developed their own laws and institutions which the ILD terms the "system of extralegal norms" to make up for the shortcomings of the official legal system. The following briefly summarizes the extralegal norms in the three subsectors examined in *The Other Path*.

1. Informal Housing

An entire set of extralegal norms exists in informal settlements which regulate, to some extent, social relations, offsetting the absence of legal protection and gradually winning stability and security for the acquired property rights. These norms are voluntarily adopted by the informals.

When land is invaded, an "invasion contract" is established to govern the settlement and the residents' organization. The contract includes provisions both for (1) establishing the settlement, e.g., establishing the plans, distributing the land, taking the initial census of the invaders and for (2) assigning responsibilities within the informal organization, e.g., mechanisms for electing the organization's leadership, for negotiating with the authorities, for allocating its budget, for maintaining law and order, for administering justice and even for mobilizing resistance.

The execution of the invasion contract establishes a special type of right to the land which the ILD terms the "expectative property right." This right applies temporarily until the government confers definite ownership on the members of the informal settlement or until the popular organizations are able to defend it as well as the state.

The level of investment in the buildings immediately demonstrates the level of security of the right.

The settlement maintains a simple but accurate register of possession. When the authorities give final title to the settlers, they do so based on the information in this register. Thus, in the end, the extralegal system manages to satisfy the expectation of ownership.

The informal organizations are democratic with a well defined organizational structure, including elected central leadership (executive body) and a general assembly (deliberative body). The aim of the central organization is to protect and increase the value of the property acquired by negotiating with authorities, preserving law and order, registering properties, administering justice and trying to provide services. There are settlers' dues to cover the costs of stipends for the organizations' leaders, public works, complying with bureaucratic procedures and a fund for bribing public officials. The organizations prepare budgets which are submitted to the assembly for approval.

While the extralegal norms provide some degree of structure and security for the informal settlements, the costs of the extralegal system are high: invaders must organize their invasion, risk eviction or relocation, put up with long periods of insecure occupation, live without benefit of basic services and waste a large portion of their resources because they must be physically present on the land to ensure their rights. Also, the expectative right, even when solidly established, does not confer the same rights as legal ownership since selling the land or renting the buildings is prohibited by law.

2. Informal Trade

An extralegal system has been established by the Peruvian street vendors to bring order to their informal activities. The vendor has a special relationship to the space he occupies in that the space remains the same and the vendor may exercise certain rights over it. However, it is not the same as a formal right since it governs a piece of street which is open to public use. The ILD calls the informals right the "special right of ownership." This special right in fixed locations helps to increase the scale of the operation and enables vendors to specialize since, with more space, vendors may store goods. A fixed location also assists the vendor to establish a commercial reputation among buyers, suppliers and creditors that is difficult if he is itinerant.

To obtain exclusive use of a location, the vendor must repeatedly occupy it. As more vendors occupy the same general area, this exclusive use is reinforced by ties of proximity and shared interests.

To better secure their special rights of ownership, street vendors seek additional means of recognition by the authorities, the most important of which is the payment of the "sisa," or an occupancy tax for their location, to the municipal authorities. Payment of this tax is generally accepted as indirect recognition of the vendors' rights to their location.

The street vendors in economically valuable locations organize themselves in self-defense organizations to protect their sites from further invasion, from resistance by residents harmed by their activities and from repression by the authorities.

There are many disadvantages to the extralegal norms for street vendors. Their special right of ownership is even weaker than the expectative right of property in informal settlements since sidewalks and roadways must remain open to the public. The threat of eviction is always present, which rules out any long term investment to improve the location. The power to sell a location is also limited since there is limited security in selling a piece of public thoroughfare.

3. Informal Transport

In the informal transport sector, access to routes are obtained or modified through invasions. While these invasions may be subsequently sanctioned by official recognition of the route, the rights to the route are initially obtained by invasion.

The ILD has called the right to operate on a given itinerary the "right to appropriate routes." This right is transitory and implies negotiation between informal transport operators and the state for recognition in the form of a concession.

Informal transport operators tend to organize as routes increase in value. There are two levels: committees of informal operators operating the same route, and committees grouped together into unions. In informal transport, there is no contract prior to the invasion. However, with time, the operators of the same route will organize to ward off other invaders. Organizing helps improve service to clients, allows the operators to more effectively negotiate with the authorities and keeps out new invaders.

The committees operate in a democratic fashion, electing leaders, setting up a fund for defense and determining the concerns of the majority of its members. It is an informal partnership agreement. The committee manages the routes and fare structure and also attempts to fund its own members' activities because most operators do not have access to formal credit. The more sophisticated committees also attempt to set up a mutual insurance fund for their members to cover accidents to their vehicles since most do not have access to formal insurance policies. Risks covered usually only include personal injury or material damage sustained by members as a result of an accident, and not third-party liability.

In negotiating with authorities, committees try to obtain legal recognition of their routes. At times, offers of political support are also extracted or made in exchange for speedy recognition of routes by authorities.

In exchange for legal access to routes, authorities seek fare controls. When this occurs, informals request other concessions to make up for lost income through controlled fares. Larger organizations among the transport operators have been formed which represent the informals in these negotiations. Through the actions of two influential federations in Lima, the transport operators have won a surprising set of privileges over the years, including at times and among others, cancellation of their tax debts or exemption from payroll tax, social security contributions or vehicle taxes. In tariff matters, they have won on several occasions the right to import vehicles and spare parts completely tax free.

The security and the exclusiveness of the right to appropriate routes increases over time. Sale of the right to a given route is made through one of two systems. In the "free system," a committee member can sell his share in the right at will, without having to obtain prior authorization or being forced to offer it to another transport operator on the committee. The committee keeps a register of sale of routes. The second system is

restrictive and requires that the member who sells observe an order of preference established in favor of transport operators belonging to the same committee.

The above examples illustrate the democratic nature of and evident need for the extralegal norms adopted by the informals. They also clearly indicate the flawed nature of such norms, including the insecurity of property rights, the constant danger of eviction, the lack of incentive to invest and the difficulty or even inability to sell or rent the property.

C. LESSONS FROM LAWS IN DEVELOPED COUNTRIES

The ILD has undertaken comparative analysis between the systems of rulemaking in developed nations and those in Peru. To date, its research includes rulemaking in Switzerland, Germany, the United States and Japan. The ILD has identified the following types of "good law" in developed countries which support and encourage private initiative.

1. Democratic Rulemaking

Informality is the result of rules that are out of touch with reality. These rules exist because mechanisms for citizen participation in the rulemaking process are lacking. In developed countries, proposed laws or regulations must be pre-published for comment. Once the law has been approved, an open process of feedback provides input on the actual impact, allowing for adjustment to the law as required. This process depends upon transparency in government, public access to information and a free and competitive press to oversee government's activities and to report on impact to the people. Cost-benefit analysis draws attention to the perceived benefits of the proposed law and to its costs. This analysis, when combined with public feedback, permits adequate adjustment of laws to the reality of a situation.

In Switzerland, a system of "direct democracy" is practiced in which frequent public referenda are held on proposed regulations to determine the will of the people.

The United States has a very strict system of regulatory analysis for measures which are considered to have significant economic impact. The U.S. also has provisions for "sunset laws," i.e. those which remain in effect only for a given period of time, after which their application and impact must be rigorously reevaluated to determine if the laws should be retained or not.

In Japan all rulemaking is a product of a high degree of consensus building among the people, the Diet and the Executive, with a major role in the process played by the local press.

2. Deregulation and Decentralization

Both of these measures are concerned with the process of democratic rulemaking described above. Both serve to move decision-making from central authorities to local or regional governments and/or to private entities. (Another technique is administrative simplification, discussed below).

To **decentralize** is to transfer authority to local governments. Not only does decentralization bring decision making closer to the people and provide opportunities for

feedback, but it enables development of competition. In developed countries, different local governments create different systems, for example "free zones," various types of taxes and other incentives. Insufficient incentives may cause an investor to leave one area to relocate in another which provides more attractive incentives.

In Switzerland, decentralization is a key characteristic of government. All matters not specifically identified as being within the authority of the federal government are the responsibility of the cantons or municipalities. Implementation of federal regulations is also the responsibility of the cantons.

Germany also has a strongly decentralized power structure, with each of its eleven states responsible for the enforcement of federal legislation.

Deregulation is the shifting of responsibility for economic decisions from government to citizens and the private sector, in areas where this shift is deemed advisable. There are two types of deregulation:

- elimination of barriers to exchange, i.e., to eliminate inefficient regulations that prevent competition either by restricting access to the market (licenses, regulations) or by needless distortion of contractual relationships (rent control, job security and price controls)

- privatization, i.e., to transfer the production of goods and services from the public sector to the private sector, through sale, contracting out or open competition between state and private enterprises

Deregulation is intended to promote competition and thereby more efficient operations in response to demand. It is not intended to substitute state control for control by mercantilist elites which would only perpetuate the inefficient operations of its predecessor.

3. Simplified Administrative Regulations

Simplified administrative regulations, as practiced in most developed countries, are means of eliminating long lines, excessive paperwork and red tape required by the government for any transaction. An example of the difference in practices is the amount of time required in Peru to register a small sewing shop (289 days involving a team of four persons) and that required in Tampa, Florida for the same operation (3-1/2 hours).

Simplified administrative procedures assume that citizens are telling the truth, that certain decision-making may be delegated to lower-level public servants, that random audits entailing stiff penalties in the event of infractions will ensure compliance with the regulations. Finally, a process of review and consultation with affected parties prior to and after adoption of the laws and regulations is needed to gain their support for compliance and their suggestions for improvement.

For more information on Administrative Simplification, see Section III.D below.

4. Public Information

In developed countries, laws exist which allow private citizens access to public information which does not endanger national security. In the United States,

information is obtained under the Freedom of Information act. Information is also readily accessible in Germany and Japan. In Peru, the ILD has found that even Parliamentarians do not receive the information they request from the Executive within the legally stipulated period of 10 days. Without access to public information, citizens cannot hold the government responsible for its actions nor can they protect themselves from abuse. Further, given the degree of state involvement in the economy, it is difficult for businesses to plan without this information.

5. Free Press

In developed countries, the press plays a fundamental role in overseeing the exercise of power. To achieve this, the press must be free of ties to the state and the favors it can dispense.

In Peru, privileges have been offered to owners of newspapers in return for absence of serious criticism. Further, not only do the media, especially radio and television, owe large sums of money to state-owned banks, but the state controls nearly all credit. The state is also the source of about 40% of all advertising in Peru and controls access to foreign exchange which is needed to import equipment and inputs.

The press in the United States is a key element in ensuring independent reporting on public issues and in encouraging public debate on those issues. In Japan, the press, which has an office in each of the government ministries, is very effective in obtaining information from government officials on their decisions and actions. In fact, the government relies heavily on the press to keep it informed of national opinion in order to better build consensus.

6. Checks and Balances

To ensure an adequate balance of power, as exists in developed nations, a system of checks and balances among the Executive, Legislative and Judiciary branches is needed to guarantee the effective and independent oversight over each other and over the guarantee of citizens' rights. In Peru, due to its design, the constitutional institutions and powers of the state are not well balanced. Public offices which are intended to defend the people are not independent of political control. Democratic structures within political parties are also necessary, along with transparency in the financing of all parties to avoid distribution of favors by the political parties once they are elected, based on clandestine financial support.

7. Judicial System

The judicial system should be independent and free from political pressure to function effectively. This necessitates strict application of criteria and guidelines for means and terms of appointment and remuneration of judges.

In Peru, the judicial system suffers both from its administrative inefficiency and the way in which political pressures affect both its rulings and their enforcement. Instead of acting as a check on the executive and the legislative branches as in developed nations, the judicial system in Peru is controlled by the executive which issues myriads of detailed rules and regulations to attempt to legislate all potential problems instead of depending on the judicial system to solve them as they arise based on legal interpretation. Finally,

in Peru, the judiciary is corrupt. Favorable decisions can be purchased by those with the contacts and funds to do so.

8. Public Defense

In developed nations, systems of public defense for those who chose not to seek or cannot afford other means of defense are available to all. In Peru, when a system was instituted to defend the interests of citizens with complaints or problems, as is stipulated in the Constitution, the Public Ministry which assumed this function was heavily influenced by political forces and ultimately abandoned the function. No public defense service is guaranteed by the government on an impartial basis. The ILD does provide free legal consultations in certain instances. For more information, see Module Four, Section II.C.

From its research into bad laws in Peru, into extralegal norms adopted by Peruvian informals and into effective laws in the developed world, the ILD has determined that legal institutions which protect and support private enterprise are critically important to economic growth.

In *The Other Path*, the question is posed:

> "How many investments could people in the United States and Western Europe have made without clearly defined and secure property rights, a system of extracontractual civil liability, a system of justice which protected their property? How many innovations could they have made without patents or royalties? How many assets, long term projects, and incentives for investment would they have managed to create without enforceable contracts? How many risks would they have run without limited liability systems and insurance policies? How much capital would they have accumulated without enforceable guarantees? How many resources would they have been able to pool without legally recognized business organizations? How often would they have gone bankrupt and had to start over again if they had not been able to convert their debts into shares? How many business and private institutions would have survived for generations without hereditary succession? Would they have been able to industrialize without economies of scale?"

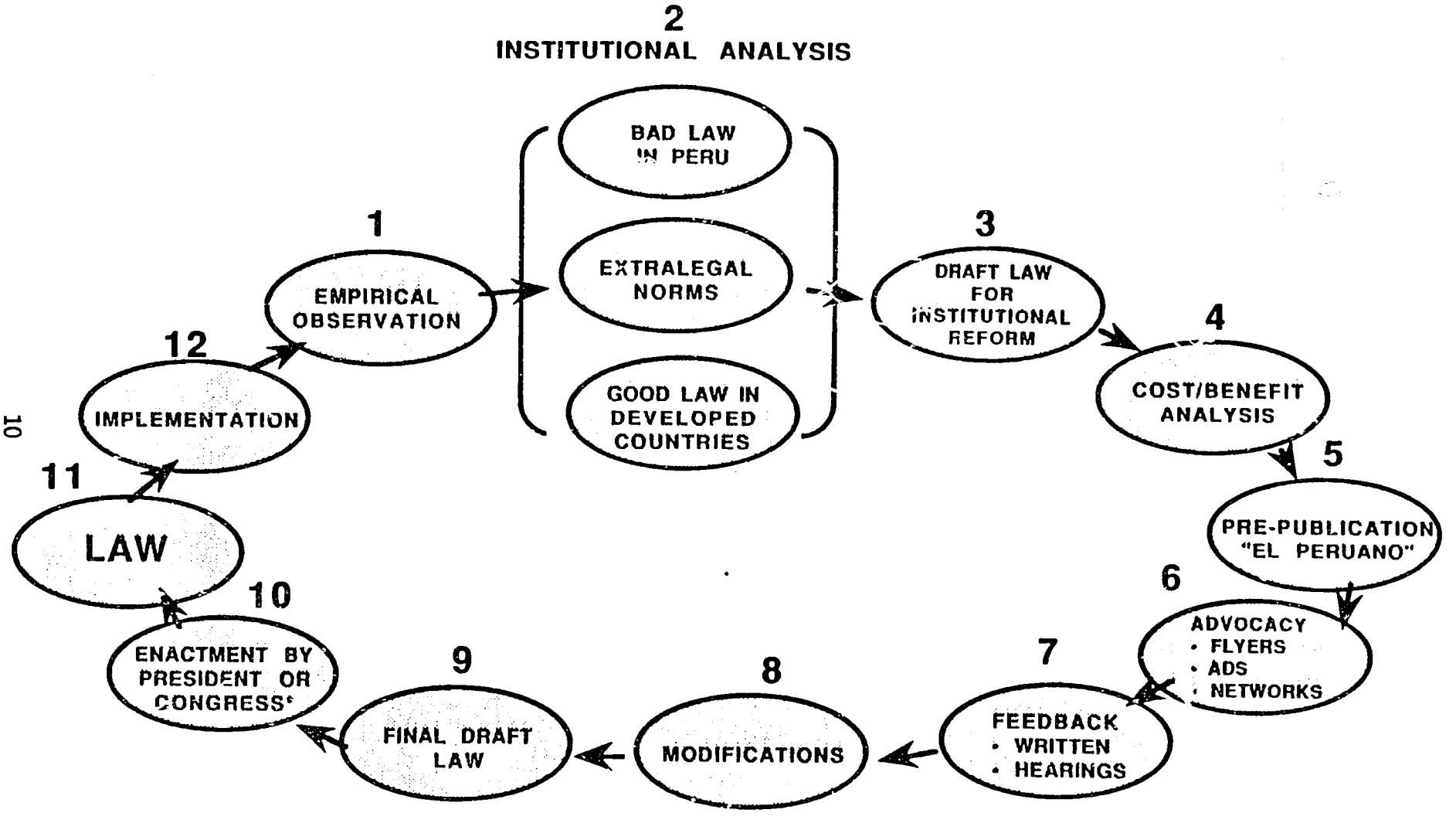
The above institutions are those which helped build the modern economies of the developed world. To promote economic growth in Peru, the ILD is seeking means to create effective institutions which will support and encourage private initiative.

III. INSTITUTIONAL REFORM PROGRAMS AT THE ILD

A. PROCESS

The ILD process for developing institutional reform proposals is depicted in **Figure 1** on the following page.

FIGURE 1: INSTITUTIONAL REFORM PROCESS



*LAWS MAY BE ENACTED BY CONGRESS (WHICH REQUIRES CONSIDERABLE TIME DUE TO COMPLEX PROCEDURES), OR BY LEGISLATIVE DECREE FROM THE PRESIDENT ONCE HE HAS RECEIVED DELEGATION TO DO SO FROM A MULTI-PARTISAN BICAMERAL COMMITTEE

As stated earlier, the ILD's process for developing institutional reform proposals is based on empirical analysis of existing conditions in Peru. Once the deficiencies are identified, a three part institutional analysis is made. First, an analysis of the extent of the failure of the legal institutions in Peru to respond to the needs of the informal majority (bad laws in Peru); second, a determination of how the extra-legal system which the informals have created helps to offset that failure (extralegal norms in Peru) and finally an examination of the institutions created by other countries which successfully confront problems similar to those found in Peru (laws from developed countries).

Once these analyses are accomplished, the ILD prepares a draft proposal for law to reform existing institutions. A complete cost-benefit analysis of the proposed reform is also prepared by the ILD. These proposals are vigorously debated within the ILD and also with the ILD's external Peruvian consultants.

The proposed law is published in the official journal, *El Peruano*. Written comments from concerned citizens are requested within thirty days. At the same time, the ILD convenes public hearings to allow for direct feedback from the public. The ILD also uses its informal sector network to contact various informal associations and individuals to obtain their comments on and support for the proposal. Once the public feedback is received, modifications to the proposal are made based on this input. The ILD also uses its institutional relationships to discuss the proposal with formal public and private sector officials, including central government figures, municipal governments authorities, legislators, formal private businessmen and lawyers. The ILD seeks to build a national consensus on the issues it raises and, as such, welcomes support from all parties, regardless of political or ideological orientation.

The formal proposal for law is then submitted to the Congress or the Executive Branch for consideration. (The ILD has found that the extremely complex procedures for enacting laws within the Congress require one or more years. It has opted more recently to submit legislative proposals to the Executive, with the request that the President ask for special authorization from Congress to issue the law as a legislative decree. That authorization is only granted by Congress if a multi-partisan, bicameral committee of parliamentarians approves the draft legislation. This process can take as little as two months from the time the draft law is proposed to the Executive).

If the law is passed, the ILD may be involved in follow-on implementation activities. (This is the case for both the Popular Mortgage and the Administrative Simplification programs).

B. COST-BENEFIT ANALYSIS

1. The Concept

The ILD began championing the need for regulatory analysis as early as 1984 in its proposals to the Belaunde government. At that time, such analysis was essentially non-existent in Peru. The government employed few policy analysts and little of the data which serves as the basis for appraising the effects of regulation in developed countries was collected by the government of Peru. The ILD was instrumental in convincing President Belaunde to issue a Supreme Decree in November 1984 which provided that all regulations, with certain limited exceptions, which would affect the incorporation of the informal sector into the legal system had to be published in *El Peruano* before their effective date, with an explanation why of the regulation was necessary and indicating

170

that any interested individual could make suggestions for modifications. The exact details of the publication requirements were to be established within three months, with technical assistance from the ILD. (The tight deadline was established since only five months remained before the national presidential elections which were expected to bring into power a left-wing opposition party not in favor of free market reforms).

With assistance from outside experts, the ILD drafted the guidelines for regulatory analysis. The key element of the decree was that each ministry must publish for public comment a regulatory analysis of any legislative proposal. For deregulatory rules, the ministry was required to provide only a simple explanation of the objectives to be achieved. For rules to increase regulation, detailed analysis and justification were required, including an explanation of the problem necessitating regulation, the objectives of regulation, if possible in quantitative terms, the means by which the regulation would achieve its objective, a detailed analysis of the regulation's significant costs and benefits and a consideration of at least one less restrictive alternative. The ILD provided a prototype cost-benefit analysis.

The ILD was prepared to assist the ministries with their cost-benefit analyses. However, the opposition to such vast changes in the legal framework of Peru was extremely strong. With elections only two months away, most ministers simply ignored the decree. Members of the formal Peruvian business community did little to advance the reform process, correctly sensing that they were potential targets of the ILD's proposals.

Despite the lack of compliance on the national level, the ILD was able to take advantage of a new municipal ordinance to illustrate the usefulness of cost-benefit analysis. In their Ordinance 002, the municipality of Lima imposed a tight system of regulation on city street vendors. The Institute prepared its own cost-benefit analysis, detailed below, and published it as a full-page ad in all of the city's major newspapers. The study concluded that the costs of the street vendor ordinance far outstripped its benefits and would result in increased consumer prices for the vendors' products.

The response to the ads was immediate and overwhelming. Street vendor associations protested the rule. Several newspapers criticized it in their editorials and gave considerable coverage to the growing controversy. As a result, the ordinance was never enforced.

The ILD has continued to conduct cost-benefit analyses for its major reforms, including the popular mortgage program and the administrative simplification program. Although the requirement to conduct cost-benefit analysis is not being enforced by the Garcia government, ministries are pre-publishing laws and the ILD is assisting in organizing public hearings.

2. Cost-Benefit Analysis of Municipal Ordinance 002

Essentially, Municipal Ordinance 002 required that all street vendors register with the city for a fee, that they pay an "occupancy tax," called the **Sisa**, that they standardize and keep their equipment clean, and that all food vendors wear aprons and gloves and use disposable packaging for the food they sell.

171

The ILD surveyed and analyzed the following elements in their cost-benefit study:

(1) Prior ordinances imposing similar regulations (historical survey from 1560 to 1985), showing that none had been particularly effective.

(2) Survey of the number of informal markets and informal vendors throughout Lima.

(3) Estimate of number of years required to obtain formal licenses and property rights to build a market (the ILD calculated that 17 years would be necessary).

(4) Growth among the informal street vendor population (the ILD calculated that the increase in informal vendors was on the order of 4.4% per year which included a 4.1% annual increase in the number of individual street vendors and a 5.5% annual increase in the number of vendors working in informal markets. Thus with an acceleration in the building and informal markets, the number of vendors on the street could decrease significantly over time).

(5) Estimate of the cost of compliance with the ordinance for a typical street vendor, including costs related to obtaining the license (time, travel, photographs, fee), to standardizing their equipment according to municipal regulations, to purchasing materials to clean their equipment, to organizing their associations by section, to paying a daily "occupancy tax" and to providing standard bribes.

(6) Estimate of the additional cost for food vendors for whom special requirements were imposed, including costs related to disposable packaging, aprons and gloves, and incidental costs related to providing samples of their products for quality tests.

(7) Estimate of the impact of compliance with Ordinance 002 on the income of typical street vendors (the ILD's calculations showed that compliance would cost the typical vendor 90% of his annual profits. For the food vendor, the cost of compliance was 4.9 times his annual profits, meaning that he would have to increase his prices considerably in order to remain in business).

(8) Estimate of the cost of compliance on the budget of vendors' associations, including dedication of "staff" to monitor compliance with the ordinance.

(9) Estimate of municipal income and expenses related to Ordinance 002, including income from the registration fee and from the occupancy tax and expenses from the cost of supervisors and "registrars" who would go to the vendors' locations to collect fees.

(10) Estimate of the net municipal income from the ordinance (the ILD calculated that the municipality would lose money in enforcing the ordinance).

(11) Estimate of the impact of possible regulatory reforms on the time required to construct an informal market (the assumption was that if additional informal markets were constructed, many of the street vendors would move from the street to these markets) the ILD calculated that by reducing the requirements

for complicated paperwork and by facilitating access to credit for construction of the markets, the time required to construct such markets could be reduced from 17 to 6 years. The ILD's figures showed that with this reduction in the time required, all of the existing street vendors could be housed in informal markets by 1991 and only 19,500 new street vendors would be present on public sidewalks, as compared with the more than 70,000 on the streets in 1985.

C. POPULAR MORTGAGE CASE STUDY (HIPOTECA POPULAR)

While displaying strong entrepreneurial characteristics and generating 40% of Peru's GDP, the informal sector as a whole lacks access to credit, the essential ingredient for economic growth and business expansion. These informal entrepreneurs cannot meet the legal requirements to apply for formal loans and are thus excluded from Peru's formal credit markets. They are left to seek informal credit at exorbitant interest rates or rely on formal microenterprise loans. In 1985, only 0.2% of total available formal credit went to the informal sector.

Mortgages provide one of the primary sources for funding for small business start-ups and expansions. (In the United States, 80% of small business start-ups are financed by mortgage credit). In Peru, the informal sector holds an estimated $16.5 billion in land and housing, which cannot be mortgaged because they lack legal, registered title. The ILD has proposed a program to bridge the gap between the informals and the formal financial institutions in Peru.

1. Description of the Program

The ILD's program has three essential elements:

- The creation of a **Registry of Possession** (rather than of ownership) allows informal entrepreneurs to register their land and houses, granting them the same property rights enjoyed by formal owners.

- **Popular Mortgage** enables a large sector of the population to use the value of their land and houses, recorded in the Possession Register, as guarantees for loans.

- The establishment of **Credit Insurance** makes insurance companies responsible for evaluating credit applications and for providing guarantee of repayment to formal financial institutions.

With this new system, an informal entrepreneur who has registered his property will have the right to use it as a guarantee for a loan. However, because informal entrepreneurs require smaller loan amounts due to the size of their businesses, they are not attractive customers to formal financial institutions, since managing many small loans is very costly and cumbersome for such institutions. The Credit Insurance program solves this barrier by bringing in the insurance companies to back up the informal entrepreneurs.

2. Benefits of the Program

Feasibility studies indicate that, after five years of operation, the system will provide the following economic impacts:

- 105,000 informal entrepreneurs will access the formal credit market. This represents a 75% increase in the number of individuals presently receiving loans issued under micro or small enterprise credit programs run by non-financial institutions

- the informal sector will receive $111 million of the total credit available in the credit market, or 12.3 times the amount issued presently by non-financial institutions to micro or small enterprises.

- in comparison to small business loans issued by the World Bank, A.I.D. and the Interamerican Development Bank, loans available through the Popular Mortgage System will be three times higher than those issued by the first two organizations and 14 times higher than those issued by the IDB

- GNP will grow an estimated 0.6% annually

- 111,000 new jobs will be created, representing a 4% increase in the number of adequately employed individuals

- Government will be able to collect $13 billion in taxes per year as a result of increase in business activity.

D. ADMINISTRATIVE SIMPLIFICATION CASE STUDY

Having identified the Peruvian law as the barrier between the formal system and informal entrepreneurs, the ILD compared the regulatory process in Peru to that of developed countries and discovered the major difference is that in developed countries, laws and regulations reflect the will of the majority of the people. However, in Peru, the only mechanism for public participation in government is the election process. Once the president is elected, the people have no means of participating in the regulatory process or of holding the government accountable for its actions. Lacking any means of receiving feedback from the public, laws and regulations are adopted in a vacuum by politicians and bureaucrats who are out of touch with the real world in which the majority of Peruvians exist.

The Administrative Simplification Program as proposed by the ILD creates a means of eliminating long lines, excessive paperwork and red tape required by the government for any transaction. Most importantly, the program ensures that the simplification agenda is set by the public and not by politicians and bureaucrats.

The Administrative Simplification Program was created by a law drafted by the ILD, unanimously approved by Congress and signed by the President on June 11, 1989. The draft legislation was discussed at two public hearings, once prior to submission to Congress and once after.

The Administrative Simplification Program was enacted by the government on September 1, 1989, in a signing ceremony involving President Garcia and his entire cabinet, which took place at the ILD and during which President Garcia indicated that full priority would be given from that day until the end of his presidential mandate on July 28, 1990, to enacting all the provisions of the program, as well as those of the Hipoteca Popular program, discussed above.

1. Program Description

Under the program, the government is required to:

- presume that citizens are telling the truth. This substantially reduces the nonsensical requirements for paperwork and certification which had to be submitted to prior to enactment of the law.
- identify and eliminate unnecessary obstacles
- reduce the cost of and streamline necessary procedures
- decentralize decision-making by delegating appropriate responsibilities to lower-level public servants
- guarantee that the public participates in the simplification process by establishing appropriate mechanisms for feedback and evaluation
- rely on random audits rather than a comprehensive audit of every individual going through the system. After-the-fact penalties will be significantly more severe than those imposed previously.

2. Public Feedback: The Citizens' Councils

The ILD pre-published the proposed regulation in the official gazette and requested that comments be sent in. A special Citizens' Council was appointed to receive public feedback and ensure that it was incorporated into the regulation. The members of the Citizens' Council represented a broad cross-section of formal and informal businesses and labor unions and also included government bureaucrats. This broad cross-section also resulted in the coverage of all political tendencies.

After receiving extremely useful public feedback at the public hearing and in writing (46 measures were added to the regulation from 339 suggestions that were received during the public hearing or in writing from citizens), the regulation was redrafted and submitted to Congress for approval.

Other Councils are being established to participate in and supervise other parts of the simplification agenda. Membership on the Councils includes formal and informal entrepreneurs, leaders of business associations, labor unions, consumers, the media and popular organizations.

Two types of Councils are being formed: sectoral (industry, housing, transportation, etc.) and special (to deal with simplification issues that affect more than one sector of the economy). The organization of these councils is be based on association customs in Peru.

The Councils' functions include the following:

- identifying cumbersome procedures in each sector
- presenting a priority list for simplification to the government or appropriate ministry or agency
- where possible, presenting solutions to the problems faced by individuals in each sector
- ensuring that no new obstacles are generated by the public sector
- supervising the proper implementation of the Simplification Law and accompanying regulations
- using the media and other lobbying efforts to ensure that the government acts on the simplification agenda as submitted by the Council
- ensuring that the Council always encourages broader public participation through public hearings or written feedback

3. Bureaucratic Accountability: the Administrative Simplification Tribunal

As an outgrowth of both presidential and public interest in the Administrative Simplification program, the ILD suggested that an Administrative Simplification Tribunal be organized to review citizens' complaints about excessive bureaucracy and to charge government officials with making necessary changes normally within five working days. Citizens' complaints are received by the ILD, the National Institute for Public Administration and local newspapers and television networks. They are reviewed and validated by the ILD staff and certain cases are selected for public "denunciation" during special Tribunals held on Saturdays. During the early days of the program, President Garcia himself reviewed the cases and called upon the various ministries to make immediate changes in regulations to avoid unnecessary bureaucracy. The ILD prepared tables of the accusations, including the source, case, description, government office and official responsible for the regulation and the status. If there is not a prompt resolution of the bottlenecks, public officials are subject to disciplinary actions.

TAKING ON THE BIG GUYS

During the first of the ILD's Administrative Simplification Tribunals, President Garcia read an accusation against his own Minister of Economy and Finance, who was charged with requiring the presentation of documentation expressly mentioned as no longer needed for the placement of ads in local newspapers to sell secondhand items. The Minister himself was given ten working days to solve the problem and ensure that his bureaucracy applied the new regulations. At the next meeting of the Tribunal, it was announced that the necessary steps had been taken and the documentation in question was no longer being required of any citizen.

4. The ILD Suppo...

The ILD is providing staff support to all the Councils, whether they be special or sectoral. The staff for each Council will be responsible for:

a. Administration

This includes staff support for correspondence, invitations and materials preparation and distribution for meetings of the Councils or public hearings, as well as all logistics to hold such meetings. This also includes notices to all members to attend, writing and distribution of minutes of the meeting, briefing Council coordinators, etc.

b. Public Affairs

This includes contacting the media to attend the meetings, as well as coordinating coverage of the events in the media and preparing press releases or interviews on given topics. Minutes of the meetings will be summarized for diverse audiences. The ILD will also assist in coordinating the lobbying effort when the Council presents its lists of requirements to the government.

c. Technical Expertise

In sectoral councils such as housing, transportation and commerce, the ILD has a body of knowledge which it has accumulated over may years of research in these areas. The ILD staff person will be responsible for keeping abreast of regulations affecting his or her sector and for drafting proposals which the Council will consider. Areas which have not been studied as yet by the ILD will require new research initiatives and/or subcontracting of studies.

d. Political Affairs

The ILD staff member will also be responsible for the liaison activities with the different ministries, politicians and agencies involved in a Council issue. This involves preparation of correspondence for the Council's coordinator and arranging of interviews and appointments with the pertinent officials.

5. Anticipated Results

Through the Council process, at least 9 sectors of Peruvian social and economic activities will be covered. The following results are anticipated:

- For each sector, the ILD will conduct a detailed study of the problems as seen by individuals who work in that sector. Through this process, the ILD will also identify areas which will require economic and/or political reforms beyond the Administrative Simplification Law.

- Through the Council process, the public will exercise their right to participate in the regulatory process and to demand that their recommendations be acted upon by the government.

- The government, particularly the Executive Branch, will have to account to the citizens for their actions. Through public hearings and press coverage,

issues concerning administrative simplification will be made public, increasing the pressure on the government to act upon recommendations for change.

Public participation in the regulatory process will also provide policy makers with direct feedback, bringing them into closer touch with reality and enabling them to make decisions based on more objective and complete information.

6. Method of Evaluation

The ILD staff person responsible for each Council will report on the Council's progress with regard to the following areas:

- Public participation on the Council: members, attendance, election processes, internal rules for proceedings, etc.
- Actions taken: public hearings, media events, lobbying efforts
- Regulatory agenda: numbers of rules and regulations studied, simplification agenda for each Council, successful results from lobbying activities
- Proposals for specific changes in the economic or political process over and beyond the simplification agenda
- Media presence

7. An Exercise in Democracy

Although the Administrative Simplification Law deals with the most visible dimension of the bureaucratic intervention in society, and therefore does not pretend to be a more systemic reform, its key component is the precedent for the institutionalization of public participation in the regulatory process, and is, as such, an exercise in democracy in Peru. By establishing the Council mechanism for feedback from the public and for accountability from the state, the public at large will gain confidence in its ability to demand that laws and regulations be established based on consultation with those who must ultimately comply with them.

The ILD expects that it will become obvious very quickly to the public that information is not public and the regulatory process is not democratic. At that point, it is expected that the people themselves will push for further economic and political reforms.

While the ILD has already developed many proposals for institutional reforms, it feels strongly that in a democratic process, those proposals for change must come from the people. The ILD expects that the Council process will serve ultimately to set the agenda for change.

The major role of the Administrative Simplification Program is to set the precedent for public participation in Peru. In developed countries, it has been shown that it is the will of the people, when translated into laws and regulations, which promotes economic growth and prosperity. If successful, the Council process under the Administrative Simplification program will prove that democracy and market economics are viable options for change in the Third World.

The following is an excerpt from an article by James Br..e in the *New York Times*:

THE PERU REVOLUTION:
LET'S ASSUME ALL CITIZENS ARE HONEST

"Clutching a thick pension file, Natividad Chirinos Contrega was happy to learn that she no longer needed a certificate proving to bureaucrats that she was alive. "They seem to be simplifying things a bit," the 64-year old seamstress said during a lull in her nine-month battle to win a pension from Peru's social security service.

Reversing four centuries of tradition in this former Spanish colony, Peruvian civil servants are now instructed to presume that citizens tell the truth.

Peru's leap into the unknown came on June 11, when President Alan Garcia abolished a series of requirements built on the premise that citizens are liars until proven honest. Those requirements included certificates of good conduct, of widowhood, of good health and of residency.

"Now the state has to accept your word," said Hernando de Soto, an economist whose private research center, the Institute for Liberty and Democracy, drafted the bill. "The state can check. If they find you've broken the law, they can throw the book at you."

The new law is a fruit of a growing rebellion against bureaucracy in Peru. In October, a law is to go into effect that will radically simplify the process of gaining title to land.

In other Latin American nations, notably Brazil, "de-bureaucratization" movements have become popular in recent years. But de Soto says he believes that Peru has a special urgency. In the past year, Peru's gross national product fell by 23 percent. Over the past 15 years, living conditions have failed to improve for the growing population, now 21 million.

In the halls of the National Institute of Social Security, Peruvians say they back the simplification program, which is marketed under the slogan "Your Wor' is Enough."

"It's nice to know that our word is now worth something," Mery Cardenas Castillo said. "But they still seem to have lost my father's employment records." "

IV. NEW PROJECTS

A. DEMOCRATIC RULEMAKING

The ILD's Democratic Rulemaking project includes the work of several circles. First is the study of rulemaking in other developed countries, which has concentrated on studies in Germany, Switzerland, Japan, the United States and, to some degree, Hong Kong. Studies on Singapore, South Korea and Taiwan are planned. Second is a complete study of rulemaking as it is practiced in Peru, highlighting the deficiencies and detailing the process in twelve specific cases of "bad law." Third is the study of non-government rulemaking in Peru, for both the urban and rural environments. The results of the work of these various circles will support the final recommendations which will be developed under the circle headed by Hernando de Soto and entitled: "Global Institutional Reform Program," to address not only recommendations for major institutional changes in Peru, but also those applicable to most of the developing world.

The high priority that President Garcia has given to the Administrative Simplification program has allowed the ILD to begin discussing its democratic rulemaking reforms in earnest with the government. The ILD is now preparing a General Statute on Democratic Lawmaking which would serve as the framework for the rest of the legislative reform process.

B. AGRARIAN LAND TITLING

When the ILD published its proposal for the popular mortgage program which would provide title, mortgage credit and credit insurance to urban informal property holders, they were approached both by representatives from the small farming communities in the countryside and by members of communal farming associations, who indicated their desire to obtain secure property rights and access to credit. The ILD is presently preparing the terms of a study on rural property rights.

1. The "Parceleros"

The "parceleros," or small farmers, were traditionally individual land-holders. However, in 1969 the military dictatorship in Peru imposed an agrarian reform program fundamentally based on large state-owned cooperatives which were characterized as "production cooperatives." It was decreed that the land was owned by cooperatives and not by individual persons. This system was an utter failure. The cooperative leaders had absolute power and all sorts of economic privileges, due to their relationship with the government. The members of the cooperatives realized that each of them received the same treatment, whether he worked or not. Everyone therefore opted for working as little as possible and for demanding as much as he wanted or needed.

After a few years, the cooperatives were bankrupt. Members decided to take things into their own hands. They deposed the cooperative leaders, divided the land among themselves and started working each for his own benefit. Things began to improve, so they decided freely to form new cooperatives, by transforming the old production cooperatives into "users" cooperatives which were firmly controlled by their membership and used to serve the members. The government ultimately was forced to accept the situation and legalize it. Today, the President himself is giving away property titles to the "parceleros".

Today's parceleros firmly support the right to private property. They are all small land holders who join efforts to get better results without sacrificing their self interest or economic independence. However, credit at market rates is unavailable to them due to their insecure property rights. Government policies of subsidizing food prices further discriminate against their growth and prosperity.

The system of "Popular Mortgage" developed by the ILD to benefit the urban dwellers could be adapted for the needs of the parceleros as well, in order to give them secure property rights, which would assist them in obtaining the credit they need.

2. The Andean or Peasant Communities

A preliminary review of the written material on the rural communities, today called "peasant communities" (comunidados campesinas) would seem to indicate that they are an association of families joined by kinship ties who use and defend a specific area of land for their own benefit. However, seen from within, it is clear that "rights" to the land are accorded to individuals, while its defense is ensured collectively.

The land has been "held" by individual families since long before the Inca Empire and this "possession" has passed from father to son without interruption since that time. Each family decides what to produce, when and how to do it and disposes of its benefits in its own way. The community does hold some land, but this is land that requires some joint effort to manage, e.g., land used for cattle grazing. Today, the influence of modern economy has tended to reduce such communal land to a minimum.

Legally, only the community has possession of the land. This means that the families that "use" the land have no property titles and cannot dispose of the land, at least legally. This reduces resources for production, makes credit almost non-existent and makes disposal of the land very difficult. Private property rights for individual peasant families "using" the land in the communities would be very useful.

The community would welcome private property rights for individual families, as long as members are certain that they could successfully defend their private land from any outside threat to their rights, e.g., expropriation from either government or large land owners.

The ILD is undertaking field work among the communities to investigate interest in property rights, market economy and participatory government.

V. GLOBAL PERSPECTIVE: THE DEBT CRISIS AND STRUCTURAL ADJUSTMENT

The debt crisis is attributable to inadequate legal institutions in developing countries. These inadequacies have permitted too much debt to be taken on and have channelled external credit flows into unwise projects.

Much debt was taken on for capital investment projects, either for infrastructure or for state-owned enterprises. The system for choosing from among projects that should receive the credits was fundamentally political, even if economic justifications were found to give priority to certain endeavors over others.

With poor legal institutions, a fundamentally political process is bound to choose inefficiently, and for the benefit of a few. This, indeed, is what has happened. Most developing countries that have taken on these loans have allowed them to be tied to particular suppliers, creating ample opportunity for shameless overpricing of contracts. These, and a series of other institutional failures, have afflicted not only the utilization of capital investment funds, but all resources that came from outside developing countries and were allocated by the governments of those countries.

The same set of legal institutions that led to the poor handling of debt initially will lead to the incomplete, inequitable or temporary implementation of policy changes supported under IMF and World Bank Structural Adjustment Programs.

> "Structural adjustment is not the same as institutional reform ... without institutional reforms to go with the policy changes (of structural adjustment), those countries that implement these programs will adopt the trappings of free markets, but will continue to lack the legal institutions that ensure the political and social viability of economically sound policies."
>
> Hernando de Soto, from the preface to the paperback edition of *The Other Path*

One defect of these policy proposals is that they follow the same top-down channels of creation and implementation that have been responsible for chaotic policy until now.

During a recent experience in Peru, the ILD observed the positive effects of structural adjustment from the bottom up, as opposed to the top-down approach employed by the IMF and World Bank. The policy at issue, tariff reform, is a staple of official structural adjustment programs.

Faced with a government veto of a requested fare increase, the informal transport operators of Lima were preparing to strike to demonstrate their opposition to what they considered unjust control on the part of the government in light of continuing rampant inflation in Peru. The informals consulted with the ILD on a means of defending their cause. After carefully evaluating the situation, the ILD advised the informal transport operators to lobby the government for the enactment of a package of measures that included the reduction of taxes and tariffs and the removal of duties on tire imports and spare parts.

The ILD calculated that the duty-free import of tires alone would directly benefit over 300,000 informal transport operators. Further, five million public transport riders would indirectly benefit through the maintenance of fares at the government-proposed level.

The Peruvian government, known for its opposition to structural adjustment and IMF-imposed austerity programs, agreed to these measures with a willingness that would have been impossible had the adjustment been proposed by the IMF. The government agreed

to the measures because they were supported by a groundswell of public support, support coming from the bottom up.

The irony of the situation was that Goodyear of Peru, a multinational based in the pro-free trade U.S.A., opposed the trade liberalization for tires, filing an appeal that temporarily blocked the duty-free imports and sought to permanently rescind the measure. The arguments used by Goodyear to justify its actions were the defense of the domestic tire industry and the protection of 1,258 jobs in the domestic tire industry. (The ILD calculated that the sales price of domestically manufactured tires was 2.5 times greater than that of imported tires. In real terms, the ILD calculated that the liberalization of the tire industry would represent a $101 million savings).

Beyond the irony of Goodyear's opposition is the jolting fact that a company that produced goods at 2-1/2 times the international price could obstruct a reform supported by thousands of informal entrepreneurs who provide very low cost transport services in virtually every area of the capital city. The ability of a powerful local firm to block the reform is proof of Peru's mercantilist system which imposes excessively high transaction and legal costs on domestic producers.

The ILD went to court to defend the informal transport operators and won. Tires and spare parts were imported duty-free and the informal transport sector worked with the ILD in establishing a "Bill of Twelve Economic Rights," which they now have adopted as their platform.

The ILD has shown that structural adjustment will work as long as costs and benefits apply equally to all. Unlike the informal transport operators in Peru who are well organized and were assisted by the ILD's technical expertise, not every group of local entrepreneurs can lobby their government for structural adjustment programs that meet their needs. There are no institutions in place which could assist them in this process through provisions for democratic formulation of laws, comment and review periods, public hearings or cost/benefit analyses. There is no ready access to public information. The executive branch is not subject to the prior authorization of Congress in the adoption of trade barriers, when Congress is, at least in theory, the branch of government most in touch with the needs of the people.

With the types of institutions in place in the developing world today, structural adjustment from the bottom up is not possible. Structural adjustment programs instituted by the IMF and the World Bank, with support from foreign governments, can only appear imperialistic since the poor majorities have no voice in their definition.

The focus of these agencies, if they are to attain their objective, must be on facilitating the institutional changes that will permit successful, bottom-up policy reform. As de Soto noted in the conclusion of his May 19, 1989 article in the *Wall Street Journal*:

> "How do we encourage structural adjustment from the bottom up? Any program for resolving the debt crisis should specifically promote institutions that create incentives for and protect the rights of the unorganized majorities of the Third World. This will allow the "informal Boston Tea Party" to achieve the objectives without resorting to force. It also will prevent the impoverished majority (who must ultimately bear the burden) from despairing and accepting violent terrorist solutions, employment by drug lords or massive emigration to the U.S.
>
> If as a major component of any structural plan, debt negotiators insist that the majority of our citizens be granted a more effective means for accessing their government, then we will be attacking the causes of underdevelopment as well as its effects."

GLOSSARY

Checks and Balances — A system of institutional controls which ensures an adequate balance of power among the Executive, Legislative and Judiciary branches of government, designed to guarantee the effective and independent oversight of each branch over the other and the protection of citizens' rights

Citizens' Councils — A series of special councils created under the ILD's Administrative Simplification program which are designed to receive public feedback on proposed reforms to administrative regulations and to incorporate valid suggestions into the final regulations submitted to Congress or the President for approval. Members of these councils include representatives from formal and informal businesses, labor unions, the media and government officials. Two types of councils exist: sectoral and special, the latter dealing with issues that affect more than one sector

Comunidados Campesinas — Andean or peasant communities which officially hold "communal" title to land, but which, in fact, have distributed individual plots of land to individual farmers who are interested in exploring means of acquiring secure individual title for purposes of investment, credit and sale of the land

Cost-Benefit Analysis — A detailed analysis of the cost of a proposed regulation as compared to its presumed benefit. This type of analysis must demonstrate to the public that some public good will be achieved by a proposed regulation at a cost that is reasonable for the benefit derived

Decentralization — To transfer authority from central government to local governments, which brings decision making closer to the people and provides opportunities for better feedback

Democratic Rulemaking — A program to make lawmaking more open to input and feedback from those concerned

Deregulation — The shifting of responsibility for economic decisions from government to citizens and the private sector, in areas where this shift is deemed advisable. Deregulation can involve either elimination of barriers to exchange which restrict access to markets or distort contractual relationships; or privatization of the production of goods or services which was formerly accomplished by state enterprises

Expectative Property Rights	The provisional property right established by an invasion of land, which serves in lieu of official property rights. This extralegal norm is based on the informal settlers' assumption that they eventually will be granted legal title to their land
Extralegal Norms	A spontaneously generated body of rules commonly understood and accepted by those affected, which normally has no standing in official legal circumstances
Invasion Contract	Agreement reached by informal invaders regarding the establishment, demarcation and land distribution of a settlement; and the functions and responsibilities of the informal organization which will provide leadership, maintain law and order and defend its residents
Mercantilism	The economic doctrine prevalent in Europe with the decline of feudalism and until the eighteenth century that served to protect selected local industries through tariffs on imports and the creation of monopolies. Those parties with access to power obtained important privileges. Parallels to European mercantilism of this period exist with the current economic doctrine practiced in Latin America and in other Third World countries
Parceleros	Traditional small holders in Peru who have no property rights to their land although it is held and farmed by individual farmers
Popular Mortgage	A current three-part the ILD program to provide informal settlers with a registry of possession of their land, a system to obtain mortgage credit based on their legal title and a scheme for credit insurance which makes insurance companies responsible for evaluating credit applications and for providing guarantee of repayment to formal financial institutions. This program will open the door to formal credit for informal settlers for the first time.
Right to Appropriate Routes	An extralegal norm whereby informal transporters try to establish exclusive rights to operate along specific routes. Transport associations may buy and sell shares of a concession to individual drivers, and negotiate with the government to obtain de facto recognition of their concession
Sisa	An "occupancy tax" on a given commercial location, derived from the European "assise" or "location tax," charged to street vendors and often considered to award unofficial recognition of the vendor's right to that space. Many street vendors pay a higher sisa than do formal sector merchants.

Special Right of Ownership

An extralegal norm developed by informal street vendors to establish claim to their fixed locations, defend their space against incursion by others and sell the rights to the space when they no longer need it

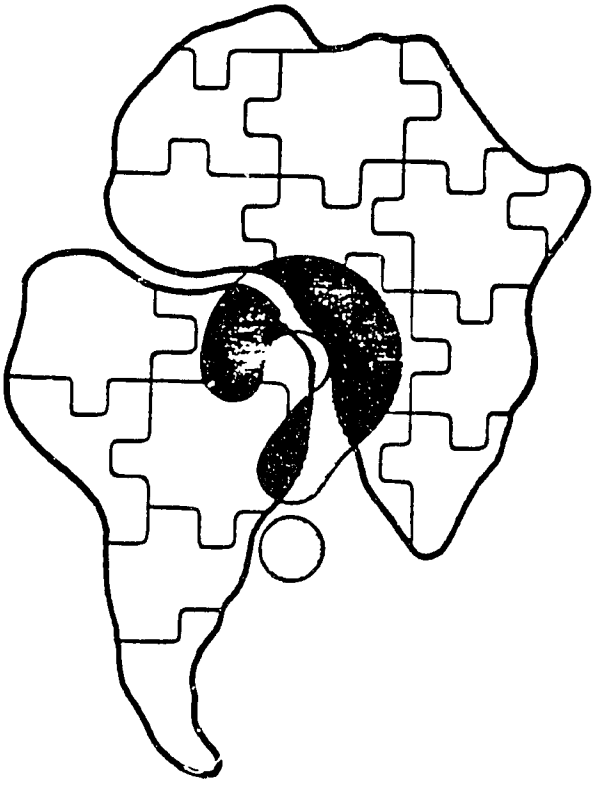
- SECTION 4 -

ILD TRAINING PROGRAMS: MODULE 4

TRAINING PROGRAM FOR AFRICAN RESEARCHERS
IN ECONOMIC ANALYSIS OF INFORMALITY
AND INSTITUTIONAL REFORM

MODULE FOUR:

EFFECTING CHANGE THROUGH ADVOCACY



November 27, 1989 – December 5, 1989

Sponsored By:

Institute for Liberty and Democracy
Lima, Peru

Agency for International Development
Bureau for Africa, Office of Technical Resources

MODULE FOUR

EFFECTING ECONOMIC CHANGE THROUGH ADVOCACY

TABLE OF CONTENTS

I. INTRODUCTION 1

II. THE ADVOCACY PROGRAM 2

A. PROGRAM OF PUBLIC EDUCATION 2

1. Institutional Reform Proposals 2

a. Publications 2

b. Public Comment 2

c. Networking 2

(1) Informal Sector Network 4

(2) Formal private and public sector contacts 5

2. Program of National Dissemination 5

a. The Media 5

(1) Press 5

(2) Radio and Television 10

b. Publications 10

c. Events 12

B. PROGRAM OF INTERNATIONAL DISSEMINATION 12

1. Publication of *The Other Path* Outside Peru 12

2. The ILD Washington Office 12

3. International Press 13

4. Conferences 13

5. International Training 13

6. The ILD Information Center 14

C. PUBLIC DEFENSE: THE POPULAR DEFENSE PROGRAM 14

1. Class Action 15

2. Administrative Simplification Tribunal 16

GLOSSARY 17

NOTES 18

MODULE FOUR

EFFECTING CHANGE THROUGH ADVOCACY

I. INTRODUCTION

Without an extremely ambitious and effective program of advocacy, the ILD's research and institutional reform initiatives would remain an academic exercise. To ensure that concrete changes in support of free markets and participatory democracy are achieved, the ILD has developed a three-pronged approach to **advocacy**, including public education, international dissemination of the ILD's thesis and public defense. Through these initiatives, the ILD transmits its message and proposals and obtains the necessary public feedback to reinforce the democratic process of reform and validation of its conclusions as they apply to other developing nations.

The ILD has a division devoted exclusively to "Promotion and Dissemination" whose function is to create vehicles to communicate the ILD's findings to a broad public, both formal and informal, and to obtain feedback and build support for proposed reforms, both at the grassroots level and with decision-makers.

A key concern of this division is finding the right language and tools to communicate the ILD's message to those most concerned, i.e., the poor. Although ILD discovered that the informals operate through a market economy and incipient democracy, the informals themselves needed to "assimilate" the findings of the ILD's research on their activities and to implement the steps required to modernize and improve their approaches.

The basic techniques developed by the ILD to transmit its message include:

- use of issues selected on the basis of their relevance to a broad section of the population, i.e., the poor. The issue of greatest concern to the poor of the informal sector is **property rights**, which are addressed in the home titling program known as Hipoteca Popular

- use of empirical research to obtain factual data gathered directly from the formal and informal sectors, allowing identification of the most serious and real constraints faced by both on a daily basis

- adaptation of the language used to the target audience, e.g., use of the phrase "popular economy" rather than that of "market economy"

- use of popular communications media (press, radio and television) directed to the target group, plus use of the informals' network to directly inform the informal sector

- reinforcement of democratic concepts in the programs to establish these practices as a common usage, e.g., ensuring feedback and review of all legislative proposals in public hearings or in writing, before a law is drafted in final

II. THE ADVOCACY PROGRAM

To achieve its ends, the ILD has initiated an ambitious program of public education, international dissemination and public defense. **Figure 1** on the following page illustrates the nature of these three activities.

A. PROGRAM OF PUBLIC EDUCATION

The program of public education is designed to achieve two objectives: (1) obtaining feedback on and support for **legislative proposals**; and (2) disseminating the **ILD thesis**.

1. Institutional reform proposals

To ensure a democratic approach to rulemaking, the ILD has instituted mechanisms for obtaining feedback from the people on their proposed laws and regulations. These mechanisms include publications, public comment and institutional relationships.

a. Publications

After legislative proposals are prepared, they are published as **proposals**, called "anteproyecto de ley," or preliminary proposals for law, in the official journal, *El Peruano*. At times the ILD's cost-benefit analysis of the proposed law (see Module Three) as compared to the existing law is published as well. Flyers designed specifically for the target audience, usually the informals themselves, are prepared and distributed.

b. Public comment

Written comments are requested from the public within a period of thirty days after the publication of the proposed legislation.

In addition, public hearings are organized, targeting those groups most interested in the issues being discussed, but open to the general public. For example, Citizens' Councils have been organized in the context of the Administrative Simplification project to consult with the members of given economic subsectors and interest groups to ensure that the proposed regulations facilitate rather than hamper their operations. At the first Council meeting, called to review the design of the law itself, more than 330 comments were received on improvements to the law. Forty of the suggestions were ultimately included in the regulations signed into law. Nine additional councils will be convened under the project to discuss specific subsectors concerns, such as education, health, manufacturing, etc.

Finally, through an ombudsman program, known as the ODP - Officina por la Defensa Popular - the ILD receives direct feedback from concerned citizens who address themselves to the ILD for complaints or suggestions (see detailed description below).

c. Networking

To build support among the people and government and parliamentary officials, the ILD relies on a series of institutional relationships it has built over time, including its Informal Sector Network and contacts with the formal public and private sector.

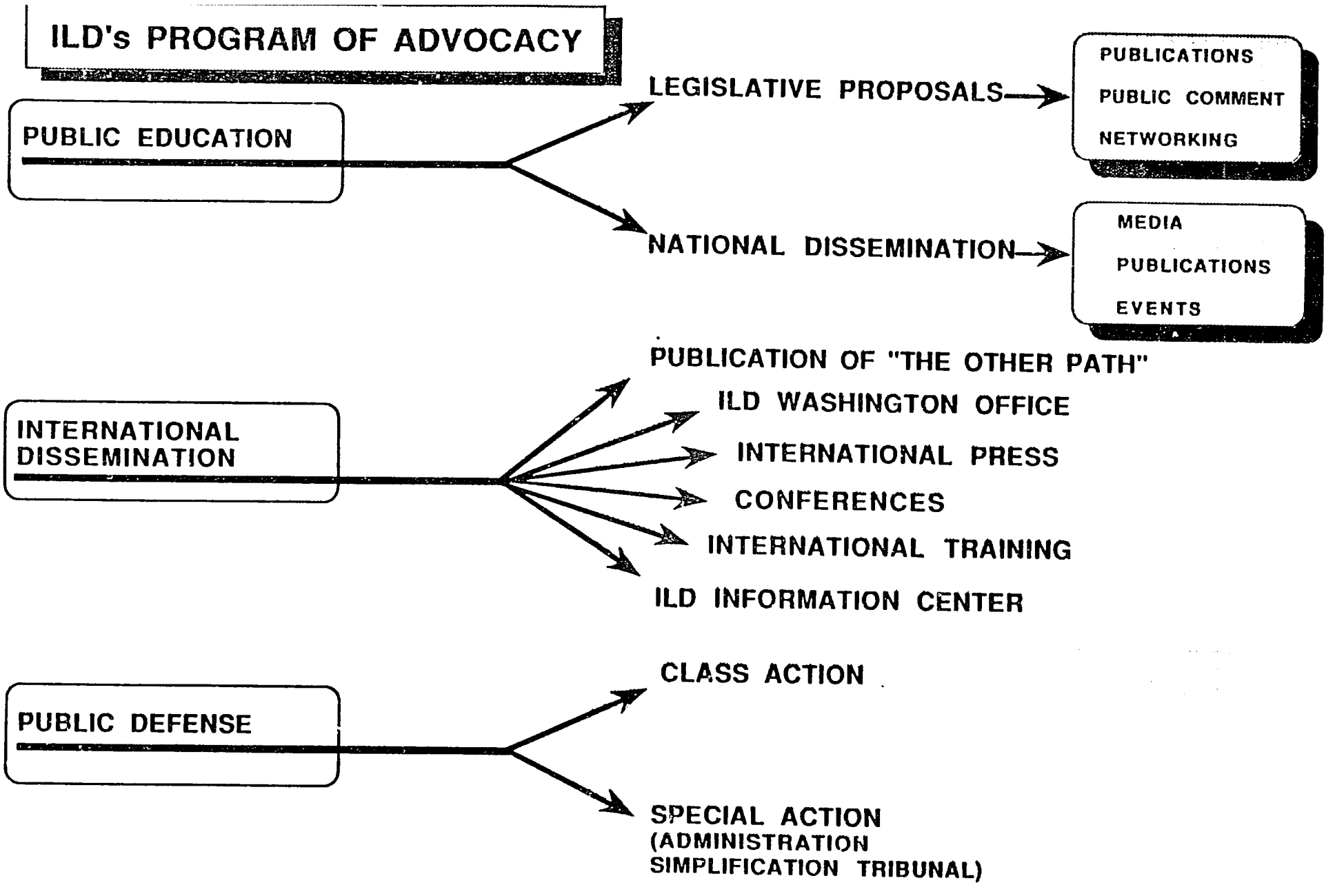

ILD's PROGRAM OF ADVOCACY
PUBLIC EDUCATION
LEGISLATIVE PROPOSALS
PUBLICATIONS
PUBLIC COMMENT
NETWORKING
NATIONAL DISSEMINATION
MEDIA
PUBLICATIONS
EVENTS
INTERNATIONAL DISSEMINATION
PUBLICATION OF "THE OTHER PATH"
ILD WASHINGTON OFFICE
INTERNATIONAL PRESS
CONFERENCES
INTERNATIONAL TRAINING
ILD INFORMATION CENTER
PUBLIC DEFENSE
CLASS ACTION
SPECIAL ACTION
(ADMINISTRATION
SIMPLIFICATION TRIBUNAL)

FIGURE 1

(1) Informal Sector Network

Contacts with the informals themselves are utilized to explain reform proposals and to develop informal sector support. The ILD also works through this network to seek signatures from concerned parties in support of a proposed law. For example, signatures from more than 300,000 persons were obtained on the ILD's proposal concerning titling for informal housing.

THE INFORMAL NETWORK

The informal sector network established by the ILD is a means of maintaining contact with key informal sector leaders and communities in order to promote support for proposed reforms and to obtain feedback from the leaders on what types of reforms will or won't work. The network is maintained through a team of persons who regularly seek out and consult with informals on all issues.

The story of one of the ILD team members responsible for maintaining contacts illustrates the varied backgrounds of those persons working to achieve the ILD's goals. This team member was a former Communist cell head working in the poor, working class district of San Martin de Porres. In 1985 when the ILD began publishing its articles in *Caretas* and in *El Comercio*, he was taken with the impact the ILD's proposed reforms could have on the impoverished majority of Peru. He persuaded the Communist mayor of San Martin de Porres to sign an agreement with the ILD to begin a program of municipal reforms to assist the 700,000 poor of his district. However, before the ILD could begin work, the national committee of the party reviewed the initiative and rejected it out of hand as being a right-wing ploy to gain support in the district. Dismayed at their political interpretation of a move to assist the poor, he publicly denounced the party's decision and broke all ties with them. (Interestingly, the mayor of San Martin de Porres was not inclined to follow his example). He subsequently began working with the ILD and became an important link in the informal sector network.

During the past ten years, the ILD has seen the informals move from a series of authoritarian, mercantilist-inspired fiefdoms among informal trade transport and housing organizations, to more democratic, market-oriented associations which are spontaneously organizing themselves to lobby and defend their objective interests. The ILD estimates that the number of informal organizations has increased from some 35-50 registered groups prior to the publication of *The Other Path*, to more than 250 today, most located in Lima. For them, *The Other Path* has become a living document whose chief contribution to the informals has been to provide an understanding of the bigger picture of the constraints they face and the force - political and economic - which they represent.

Most recently the network has been used to disseminate the ILD thesis as regards property rights in the departments of Cuzco, Arequipa, Ica, Cajamarca and Piura while simultaneously undertaking interviews for research on extralegal regulations in those areas.

(2) Formal private and public sector contacts

An entire network of contacts has been developed with the central government, municipal governments, parliamentarians, the formal sector and unions which allows the ILD to contact key leaders, discuss issues with them and obtain their support in favor of proposed legislation. For example, through this highly effective network, the ILD was able to obtain the support of all major political parties in Peru for the land titling act for informal housing and for the administrative simplification program.

2. Program of National Dissemination

The ILD has developed an extremely effective communications system to transmit its thesis concerning free markets and participatory government to Peruvians. This system relies heavily on the media, publications and organized events.

a. The Media

Broad use is made of the press, radio and television to communicate the ILD's message.

(1) Press

In the early days of the Institute, one format for press coverage proved particularly effective - a short, persuasive document called "Analyses in Benefit of the Public Interest," or ABIPs. These articles were no more than four pages, summarizing the ILD research on economic issues of special importance, using numerous illustrations and photographs to catch the public's eye and to get the message across.

The objectives of the ABIPs were to illustrate the consequences of badly made laws and to indicate the importance of adequate legal institutions for development. They focused attention on anti-democractic, anti-market legislation. The articles critiqued such legislation, demonstrating how it hurts the poor, and proposed market-oriented alternatives. The ABIPs dealt with specific problems such as home titling, rent control and labor stability, primarily from the point of view of the poor majority.

The ABIPs were published in the major circulation magazines and newspapers, reaching over 800,000 readers. In addition, they were published separately and distributed among interested groups, including informals, in flyer form.

For more than a year, from July 1985 to September 1986, the ILD was given free space in the weekly magazine *Caretas* to publish the ABIPs. In all, 23 ABIPs were published in *Caretas*, dealing with themes including street vendors, informal land invasions, urban informal transport, property rights for informals, the Public Defense Office, state monopolies, debureaucratization, reform of legal institutions, administrative simplification and privatization. A copy of the article on opposition to the Municipal Ordinance 002 to regulate the street vendors, entitled "A Question of Truth" is provided in **Figure 2** as an example of the ABIPs published in *Caretas*. (See also Module Three, on Cost-Benefit Analyses applied to Ordinance 002).

Figure 2

Cuestión de vereda

La 002: Un intento de reglamentar el fenómeno ambulatorio

La ordenanza 002 del Municipio de Lima tiene pretensiones de reglamentar una actividad cada vez más creciente.

Para intentar reglamentar el cada día más creciente comercio ambulatorio de Lima, el Concejo Provincial dictó el pasado 17 de abril la ordenanza 002. Viejo remedio el de la reglamentación, ya los virreyes lanzaron una regulación en 1553, que no siempre ha conllevado las soluciones buscadas: entre tramitaciones legales, licencias, pagos, recibos y facturas que se requieren oficialmente, el problema se multiplicaría, cuando lo que se pretende es que esta amplia capa de la población, que han dado pruebas de capacidad de ahorro y energía, se integren plenamente, no a la formalidad usual, sino al camino del desarrollo económico.

Figure 2

EN la larga historia de reglamentación del comercio ambulatorio, que iniciaron los virreyes en 1553, el último hito es la ordenanza 002 del Concejo Provincial de Lima, que fue publicada el pasado 17 de abril. Sin duda esta ordenanza, como las normas que la antecedieron, está inspirada en el deseo de mejorar la ciudad. Pero lamentablemente no es una buena norma. Es reglamentarista en exceso, motivo principal del fracaso de sus antepasadas, e ineficiente, porque sus autores han ignorado sus efectos económicos.

COSTOS

Toda regulación conlleva costos y beneficio. Las normas exigen el cumplimiento de ciertos requisitos, como medios para alcanzar sus objetivos. Cumplir con la ordenanza 002 le costaría S/. 711,000 anuales a cada ambulante. Y aquellos que venden comidas preparadas tendrían costos adicionales de S/. 3'168,000 anuales. Los ambulantes trasladarían estos costos a los consumidores subiendo sus precios por lo menos 9o/o. El impacto sería sentido especialmente en los distritos de bajos ingresos, donde se ubica el 62o/o de los ambulantes, que son allí el principal y único medio de abastecimiento de la población.

Para la administración pública, la aplicación de la norma y la supervisión de su cumplimiento puede tener un costo muy alto. Como resultado, la recaudación neta puede ser mucho menor que lo esperado.

Mientras que a los ambulantes les impone costos por un total de S/. 79,833 millones anuales, la ordenanza 002 daría a los municipios ingresos netos de S/. 6,994 millones anuales. El Municipio argumenta que la responsabilidad de supervisar el cumplimiento de la 002 recaerá sobre las organizaciones de ambulantes y que, por otro lado, serán los municipios los que saldrán a registrarlos. Con estas modificaciones, el costo total para los ambulantes no bajaría mucho; pero el costo para el municipio subiría a más del doble, y podría presentársele una pérdida de S/. 5,053 millones.

SOLUCIONES

La solución para el comercio ambulatorio consiste en que los comerciantes establecidos en la vía pública tengan tiendas o mercados para ejercer su trabajo, sin ensuciar ni congestionar las calles de la ciudad.

El Instituto Libertad y Democracia ha encontrado una marcada inclinación en ellos hacia la construcción de mercados. Esta iniciativa empresarial ha producido como resultado, en los últimos 20 años, 240 mercados en Lima donde trabajan 21 mil vendedores, más de lo que ha podido hacer el sector público: 2 mercados y 6 campos feriales para 3 mil vendedores en total. Construir un mercado, sin embargo, es un proyecto que puede consumir 17 años de esfuerzos desde que se forma la "paradita" en la vía pública hasta que el mercado está en condiciones de ser ocupado. Pero a pesar de todas las dificultades, los ambulantes construyen cada año, en promedio, unos mil puestos.

Búsqueda para que el ejercicio informal no congestione ni ensucie la ciudad.

Por comparación, el Fondo Municipal de Asistencia al Ambulante (FOMA) creado por la 002, alcanzaría para construir no más de 500 puestos por año, en caso de que todos sus recursos de inversión se destinen a construir mercados. Lo que es peor, la rapidez del tránsito hacia mercados no dependería de la capacidad de ahorro de cada organización, sino del esfuerzo dedicado a cultivar contactos personales y favores políticos de quienes administren el fondo.

Lima, desde siempre fue una ciudad donde floreció el comercio ambulatorio, ya en 1553 se trató de ordenar y reglamentar

Henry Pease: defensor de la ordenanza 002

UNA "guerra de comunicados" se desató al poco tiempo de la promulgación de la 002. El 7 de mayo, un oficio dirigido al alcalde Barrantes por la Federación de Vendedores Ambulantes del Mercado Central y Calles Adyacentes (FEVACEL), que reúne a unos 5,000 ambulantes, se quejaba de la forma antidemocrática como fue elaborada la norma y anunciaba que no estaría muy dispuesta a la reubicación, porque afectaría su "estabilidad laboral".

Días después, la Federación Unitaria de Vendedores Ambulantes del Perú (FUVAP) reclamaba su condición de reunir a "empresarios independientes, sin patrones", y criticaba uno a uno los puntos más débiles de la Ordenanza (limitación de capital, horario y ubicación, etc.).

La Municipalidad de Lima se lanzó también al ruedo, el 16 de mayo, con un aviso presuntamente firmado por 31 organizaciones en apoyo de la Ordenanza. La jugada le salió cuadrada: de las 31 organizaciones firmantes, siete ya habían protestado contra Barrantes el 7 de mayo.

El 13 de junio la FEVACEL volvió

Figure 2

Tambien debe tratarse de que las calles no se conviertan en campos cotidianos de batallas entre ambulantes y policía.

¿Qué piensan?

Habian los directamente involucrados

a la carga, advirtiendo al Municipio que no lo aceptarian como patronal, imponiendoles limitaciones. Mientras el regidor Henry Pease declaraba su intencion de defenderlos de las garras de los mayoristas, la FEVACEL respondia que los mayoristas, precisamente, les permitian trabajar, entregandoles en consignacion sus mercaderias. Y demandaba del Municipio que, en lugar de entretenerse ideando controles ineficientes, se preocupara de gestionar medios de acceso al crédito para que los ambulantes pudieran construir sus mercados.

Para enfrentar estas criticas, la Municipalidad publicó un aviso en el que 110 organizaciones de ambulantes respaldaban la Ordenanza. No solamente habia 32 nombres ya sea repetidos o que no pertenecen a organizaciones de ambulantes, sino que no hubo tal recoleccion de firmas. Aparentemente, fueron utilizados los nombres de los asistentes a un seminario en torno a la 002, apoyaran o no la ordenanza.

La FEVACEL y la FUVAP hicieron circular de inmediato comunicados publicos denunciando la patraña. Para que la cosa no quedara en menores, la Mesa de Partes de la Municipalidad ha empezado a recibir algunas cartas notariales, suscritas por engañados "firmantes" del comunicado municipal, reclamando la rectificacion a que tienen derecho. "Mea culpa" al que tendrá que someterse el Municipio, porque algunas de las cartas amenazan con abrirle accion penal por delito contra la fe publica. ■

Ese no es, obviamente, el camino del desarrollo economico. Ya que los ambulantes han dado pruebas de su capacidad de ahorro y de su energia empresarial, es necesario darles instrumentos apropiados para acelerar el progreso.

El primer paso es simplificar los tramites, ganandose tiempo y dinero, puesto que año a año los materiales de construccion se encarecen en terminos reales. El segundo es promover entre los ambulantes mejores formas de organizacion empresarial, que estimulen el ahorro y la eficiencia de los dirigentes. Y el tercer paso, muy vinculado al anterior, es darles acceso al crédito para acelerar la construccion. Todo esto abreviaria el proceso de los actuales 17 años a un solo 6.

Si se tomaran las medidas apropiadas ahora, dentro de seis años los actuales vendedores ambulantes ya podrian estar en mercados. Las calles de Lima no quedarian completamente libres de ambulantes para entonces, puesto que seguirian apareciendo otros. El ILD calcula que en 1991, de acuerdo con la tendencia historica, esos nuevos ambulantes serian unos 20 mil. En cambio, todos los campos feriales que el municipio pueda hacer

Figure 2

con los recursos de la ordenanza 002 no evitarían que los ambulantes en la vía pública llegaran a cien mil.

LA REGLAMENTACION TRADICIONAL

Pero no es sólo cuestión de costos. La 002 abunda en detalles, y supone que se cumplirán sólo porque los ambulantes son amantes de la ley, aún a costa de su supervivencia. Adicionalmente, la norma reedita los requisitos que desde el Virreinato se establecieron para el comercio ambulatorio. La cuestión de las licencias, por ejemplo, arranca en 1617. Pero ni siquiera el Auto del Excelentísimo Conde de Lemos de 1670, consiguió erradicar a quienes carecían del documento.

De 1936 a la fecha, la Municipalidad de Lima y el Gobierno han dictado 83 normas sobre comercio ambulatorio: en promedio, una cada 18 meses. Demasiada indecisión para un fenómeno que, en lo sustancial, casi no ha cambiado.

Repasando la 002 se descubre una vena tradicionalista hasta ahora inexplorada en los conventículos de la actual administración municipal. Cinco de

Un ambulante "oficial" debe desembolsar

cada seis disposiciones contenidas en ella carecen de novedad.

Desde 1560 se regulaba el expendio de alimentos. El límite al capital se determinó en 1947 y 1959. Primero fueron 500 y después 2,000 soles; la 002 lo establece en 2 UIT (unos 9

Un comercio que cubre todas las ón.

millones de soliñacios). La única diferencia se la debemos a la inflación. La 002 exige también facturas y recibos por derechos de importación. Ni más ni menos que lo exigido por el Duque de la Palata en 1674.

El uso del mandil se establece desde 1915. El color blanco ha sido el preferido, a juzgar por los 4 dispositivos que pretendieron implantarlo. Ahora el Municipio también quiere dejar a los ambulantes "tal de tiza, mamá...".

A partir de 1936 es obligatorio obtener carné sanitario.

Una ordenanza de 1947 exigía "certificado de vacuna, exámenes de sangre, radioscópico y odontológico". Afortunadamente, la ecografía y la tomografía axial son inventos recientes.

La 002 tampoco se libra del morbo controlista: dispone horarios, dimensiones de carretillas y altura máxima de los toldos. El artículo 23 pertenece a una antología de Ripley: los ropaveferos acreditarán las condiciones higiénicas de la ropa usada "con el documento correspondiente". Seguro que se refiere al "Certificado de Ropa Limpia" que expide la Dirección Nacional de Pulcritud Indumentaria. ■

■ El informe es un resumen de investigaciones del ILD, a cargo de Iván Alonso y Eduardo Lazo, equipo económico en Luis Morales Bayro; encuestas: Manuel Moyorga y Orlando Eyzaguirre, redacción: Franco Giuffra.

■ Invitamos a todos los interesados a la audiencia para discutir la Ordenanza 002 y el análisis del ILD, recogido en este informe, que se realizará el día 11 de julio a las 6.45 p.m. en la Sala 3 del Centro Cívico. El conversatorio será presidido por el Ing. Eduardo Irigoyen, Presidente de la Cámara de Comercio de Lima.

¿Cuántos son?

Se calculan 85 mil vendedores ambulantes

CUANTOS ambulantes hay en Lima? ¿Doscientos mil, 500 mil como imagina el gobierno municipal? ¿Novecientos mil como dice la CONAPLAN, según reporta "El Comercio"? Si así fuera, habría un ambulante por cada 6 habitantes, y los veríamos hasta en la sopa.

Son aproximadamente 84 mil, según un censo realizado por el Instituto Libertad y Democracia en enero, en 29 distritos (excluyendo balnearios, Chineguilla y otros distritos alejados del centro). El censo de 1976, realizado por la Municipalidad y el Instituto Nacional de Estadística, estimó 58,389, en la misma área.

El ILD fue a cada municipio distrital para averiguar cuántos ambulantes creía tener en su jurisdicción. La suma de los cálculos da una cifra inferior a la recogida por el censo del ILD. Sin contar el distrito de Lima no tenía información...

Actualmente, unos 42 mil ambulantes pagan una —arbitrio por usar las calles— en 21 distritos. La tarifa diaria varía entre S/. 150 y S/. 2,000. La recaudación total se estima en S/. 23 millones diarios, es decir la mitad de los ambulantes contribuye con más de S/. 8,000 millones anuales a los municipios.

Además, el ILD tomó en febrero una muestra de ingresos de los ambulantes en nueve distritos representativos. Por entonces, el ambulante promedio ganaba S/. 407,000 mensuales (un 18o/o de sus ventas), cifra superior a la remuneración mínima legal. Parece, pues, un mito la creencia generalizada de que el desempleo es causa del comercio ambulatorio.

¿A qué se debe este éxito? Hay una razón simple para comprarles a los ambulantes: venden más barato. Se dice que roban en el peso. El ILD salió de compras en seis distritos, y encontró, usando una sola balanza, que con los ambulantes perdió 3o/o del peso acordado, y en los mercados 5o/o. No hay, pues, mucha diferencia. Todos tratan de cuidar su buena reputación. ■

	Lima Cercado	Otros distritos	Total
Censo municipal 1976	13,565	44,824	58,389
Censo ILD 1985	16,580	67,555	84,135
Estimados de concejos distritales	n.d.*	55,248	

* n.d.: No disponible

The preparation of these articles required an intensive, two week effort by a team of five to seven persons for every four page article. The team conducted in-depth research on all issues relating to the chosen subject and then progressively condensed that information into the four-page format. The articles served to give the ILD a high degree of visibility in Peru for its reform initiatives.

In November 1985, the ILD accepted an offer on the part of *El Comercio*, the largest circulation newspaper in Lima, to publish short articles on reform issues in the newspaper. These articles were usually adapted from the *Caretas* publication and allowed the ILD to diversify its press affiliation with *Caretas*, which is considered a right wing publication. The *El Comercio* articles were published three to four times a week until February 1986.

More recently, the ILD has begun publishing one page paid advertisements to publicize independently its positions and reform proposals. An example of a recent advertisement on the Administrative Simplification ("debureaucratization") law is provided in **Figure 3** as an example.

The ILD has carefully nurtured its relationship with the local press, including both left-wing and right-wing publications. It has begun holding regular press conferences on progress made in implementing the Administrative Simplification program and the Popular Mortgage program. Press releases on the issues to be covered in the press conferences are prepared for distribution to the local press.

(2) Radio and Television

As concerns radio and television, the ILD receives approximately 2 hours weekly of free radio air time, including the radio program entitled "El Balcon de Todos," described below. An average of 5 additional hours per month of radio time in Lima is devoted to radio interviews with the ILD staff on topics of current interest.

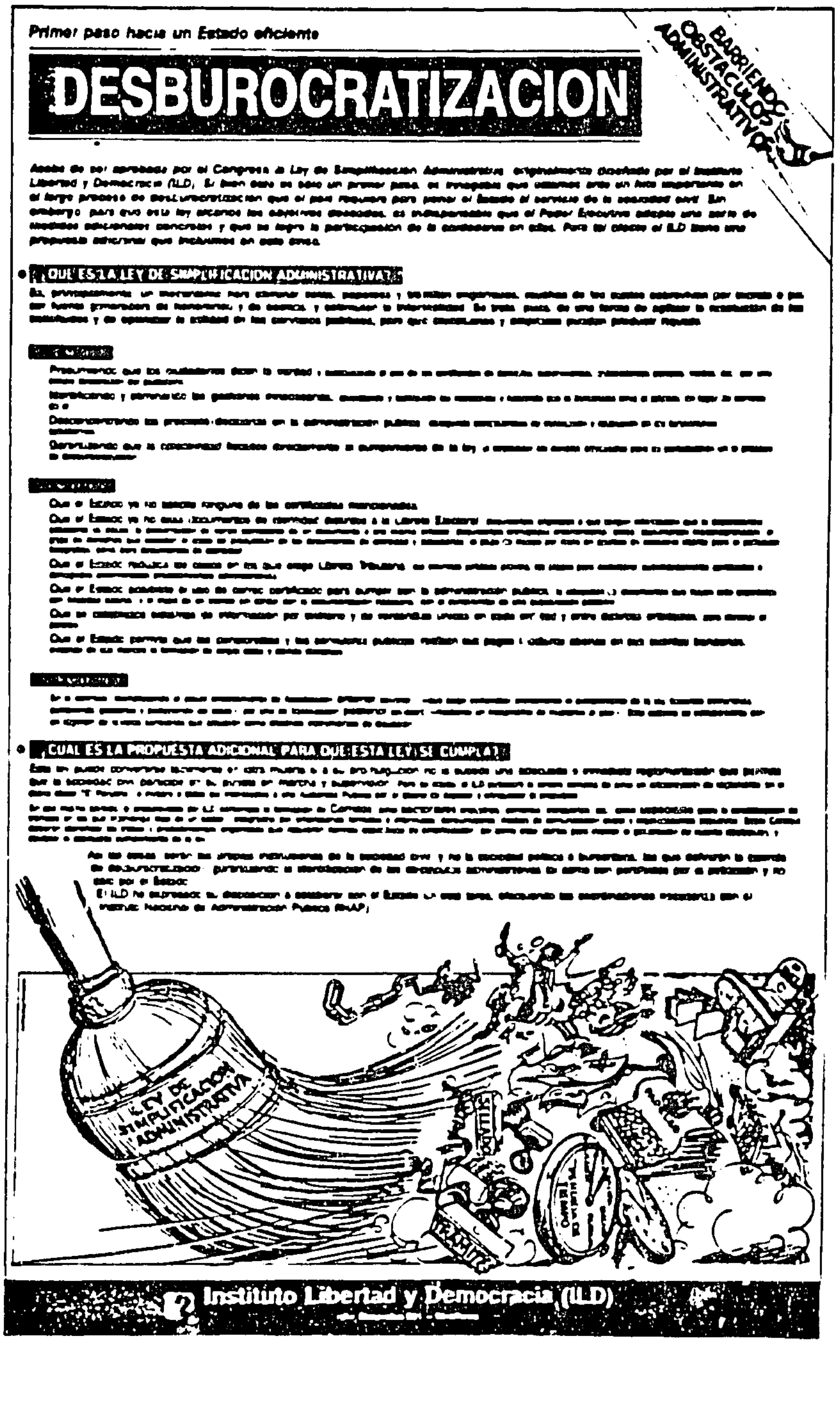
Television coverage averages at least one hour per month, in the form of news coverage or interviews or debates with Hernando de Soto or other key the ILD personnel on the ILD's activities.

b. Publications

The most important publication from a national standpoint for the dissemination of the ILD's thesis is, of course, *El Otro Sendero*. In Peru alone, over 70,000 copies have been sold. It is the Number One best selling book of all times in Peru.

Publications geared to transmit the ILD's thesis throughout Peru have included a series of "Cuaderno de Trabajo," or working papers on a variety of topics, including Street Vendors, Anti-Trust Laws, Administrative Simplification, The Mercantile State, Informal Economy and Institutional Reform, Entrepreneurial Integration: An Ideological Answer, and Laws of Labor Stability and their Economic Impact. Two thousand copies of each of these books were printed.

Figure 3


Primer paso hacia un Estado eficiente
DESBUROCRATIZACION
BARRIENDO OBSTACULOS ADMINISTRATIVOS
¿QUE ES LA LEY DE SIMPLIFICACION ADMINISTRATIVA?
¿CUAL ES LA PROPUESTA ADICIONAL PARA QUE ESTA LEY SE CUMPLA?
LEY DE SIMPLIFICACION ADMINISTRATIVA
Instituto Libertad y Democracia (ILD)

c. Events

Another means of disseminating the ILD's message is through organized national events, including conferences and debates. Joint meetings and debates with the formal sector have been organized, including a recent nationally televised debate between Hernando de Soto and a representative of the Lima Chamber of Commerce concerning the ILD's proposal for Twelve Economic Rights, and more specifically the liberalization of trade and the reduction of tariffs on imports of certain products which are also produced in Peru (e.g., tires). Round table discussions with representatives of local interest groups are also held, such as those being conducted now with bankers and insurance companies in connection with the Popular Mortgage program.

B. PROGRAM OF INTERNATIONAL DISSEMINATION

The ILD has achieved a great deal of international recognition in the 10 years since it began its operations. The ILD believes in the importance of communicating its message to the outside world, to promote the development of free markets and participatory government in favor of the poor majority in other developing countries. The feedback obtained from such dissemination is very useful to the ILD since it serves to validate the applicability of the ILD's approach in the rest of the developing world and often provides the ILD with examples of institutions which are functioning effectively in developing countries.

To ensure widespread dissemination of its thesis, the ILD has initiated a major program of "internationalization," including publication of *The Other Path* throughout the world, opening of an the ILD international liaison office in Washington, D.C., contacts with the international press, participation in international conferences, implementation of training in Peru for foreign participants and the establishment of an the ILD Information Center.

1. Publication of *The Other Path* outside of Peru

The ILD is committed to making *The Other Path* available as widely as possible. After its publication in Peru in 1986, the book was made immediately available throughout Latin America, where over 100,000 copies have been sold. Some 1300 articles have been written on it in less than one year by Latin American politicians, analysts, philosophers and journalists.

The English translation of the book was published in the United States in March 1989 by Harper & Row. From April to June 1989, *The Other Path* was on the Washington Post's list of top ten best selling hardback books. It was published in England in June 1989, in Canada in August 1989 and in Sweden in November 1989. Negotiations are underway with publishers in Africa and France for publication. An official condensed version of the book has also been produced for publication throughout the world, along with a serialized version. Such versions have appeared in Latin America and in South Africa.

2. The ILD's Washington Office

The creation of the ILD Washington office was suggested by management consultants who evaluated the ILD's organization and its efforts to meet the information requests of the international development community interested in learning more about the ILD's

programs. The ILD's Washington office allows the Institute to maintain close contact with officials from A.I.D., the Inter-American Development Bank, the World Bank, and the United Nations. This allows the ILD to better track projects and other opportunities to involve the Institute in activities related to institutional reform and to respond to requests from the international development community on the ILD's initiatives and accomplishments.

The ILD Washington office further serves to coordinate the logistical arrangements for consultants who will be working with the ILD in Peru or who will assist in carrying out comparative international research on the role of law and institutions in developed countries.

3. International Press

The ILD has been widely covered by the international press, including articles and book reviews in *The Economist*, the *Wall Street Journal*, the *New York Times*, *Forbes Magazine*, *Fortune Magazine*, *Readers' Digest*, the *Washington Post*, the *Financial Times*, to name only a few. The ILD has received requests for regular articles from the Wall Street Journal and the New York Times. The ILD attaches a great deal of importance to this coverage since it promotes the ILD's thesis throughout the world. This helps to increase the ILD's visibility and credibility in Peru, which, in turn, garners additional international attention.

4. Conferences

The ILD President Hernando de Soto receives hundreds of invitations to participate in conferences, symposia, debates and other fora to make the ILD's case. The ILD considers these occasions an opportunity to educate and to help local leaders raise interest in establishing local programs. Within its constraints of time and funds, the ILD responds to such invitations. During the calendar year 1989, de Soto has participated in the following conferences, among others: conferences on Issues in Informality, held in Abidjan, Cote d'Ivoire and Nairobi, Kenya; Wolfsberg Conference on the Impact of Development in Geneva, Switzerland, conferences on Free Markets and Perestroika held in Estonia and Moscow; and regional conference on Institutional Reform held in Karachi, Pakistan. In Washington, D.C., de Soto is regularly invited to address the major international donors and A.I.D. In the U.S. he is asked to speak by private business associations and research institutes.

5. International Training

In response to a growing number of requests for training in the ILD's economic analysis and institutional reform processes, the ILD has agreed to organize up to four major training initiatives per year in Peru and has developed training curricula and materials. Although the ILD will assist in training researchers and activists in basic approaches to institutional reform, responsibility for initiating, funding and implementing local programs will reside with the local groups.

Individuals and institutions participating in such training are of two groups: those who contact the ILD as a result of reading or hearing about its work and those who are recommended by donors or third parties. The ILD entertains all requests for training and accepts or rejects such requests based on criteria relating essentially to the degree

of motivation of such groups to initiate institutional reform programs in their home countries.

The ILD hosted a group of North African and Asian researchers in April 1989. A second group of Sub-Saharan African researchers was hosted in November 1989. Other requests training have been received from informal organizations, formal private sector organizations, universities, research organizations, political parties and governments for training.

In certain circumstances, the ILD will provide short term technical assistance to those groups actively pursuing reform programs in their home countries.

The ILD is also prepared to study requests from selected individual to participate for several months to one year in the ILD project in Lima.

6. The ILD Information Center

As a natural outgrowth of its role as promoter and trainer, the ILD has a wealth of information on persons doing research in the field of informality and the role of institutions in development. As a result of its ongoing research, the Institute will also be a source of new ideas which should be made available to those working in the field. Further, the ILD has developed and is expanding its list of consultants whose knowledge can be adapted to assist in such areas as measurement of informality, quantification of the costs of legal institutions, recognition of legal and institutional barriers, and identification of realistic and tested alternatives for institutional change.

To make this information available to those outside Peru, the ILD has created an Information Center, which is now being computerized, to facilitate the task of providing customized information to fellow researchers and activists.

The ILD is also organizing the publication of a regular newsletter which will provide a steady source of information on institutional reform. The newsletter, geared to those undertaking programs in their home countries, theoreticians and development practitioners, will focus on both the practice and theory of the ILD's programs. It will also enable groups in one country to benefit from the experience of others.

C. PUBLIC DEFENSE: THE POPULAR DEFENSE PROGRAM (ODP)

The ILD has based its public defense initiatives on the notion of a private ombudsman to support citizens in their grievances against the government and its institutions. In 1984, the ILD was instrumental in creating, within the Peruvian Attorney General's Office, the function of El Defensor del Pueblo (Defender of the People), which was part of the constitution but had never been enacted. The ILD created a support office within its own structure to assist in receiving and transmitting citizen complaints. However, political pressure was placed on the Attorney General's office by certain officials to terminate the activity, since many complaints were being received against the government. The government withdrew its support, but the ILD opted to continue its advocacy role, calling the campaign "El Balcon de Todos," or Everybody's Balcony. (This name was intended to contrast with the "President's Balcony" from which the President makes his major declarations to the people). The ILD received free air time on local radio stations to air complaints.

In 1987, the ILD opened its "Officina por la Defensa Popular" (ODP-Public Defense Office) to assist the poor with their legal difficulties. It was originally planned that a local association of lawyers would assist in furnishing legal advice. However, the ILD did not have adequate funding to pay for this service. The ILD opted to furnish limited services itself, through a group of three lawyers. Until recently, the ODP provided legal defense for class actions and certain individual suits. This service assisted informals who could not otherwise afford defense and was a means through which the ILD reciprocated for the time many informals have given to work with the ILD on institutional reform proposals. ODP also furnished an important service in support of the informal sector network, by arranging for and making presentations to groups of informals on legal and administrative issues. The work of this group was useful in informing the ILD's research and proposals on other issues.

Recently, however, in evaluating the growing number of priorities, the ILD determined that its public defense efforts would be curtailed, except for those cases in which the defense activity could assist in building a strong argument for institutional reform. The ILD felt that a time-consuming and costly public defense program, while helpful to a limited number of informals, had the same built-in disadvantage as the numerous microenterprise programs which treat the symptom but not the cause of the informals' marginality. The ILD felt that its resources would be better used to concentrate on the larger picture of institutional reform, rather than individual law suits which could only hope to change decisions relating to a limited number of persons. The ILD's basic conclusion was that if it succeeds in reforming institutions through its programs, it will no longer be necessary to provide legal defense for individuals.

The ILD does continue to provide legal services for certain cases, such as class action suits or cases which support its ongoing programs.

1. Class Action

Examples of recent legal defense in support of class action suits include:

- Casas Huertas Pueblo Joven

This case involved the request for expulsion of over 2,000 families from their informal settlement by the owners of the land. Due to irregularities in the enrollment process for the Public Real Estate Registry and due to the classification of their property as a *Pueblo Joven*, the former owners of the land occupied by the Casas Huertas settlement were not paid the appraised value as required. They sued to obtain recovery of their land and expulsion of the 2,000 families living in the settlement. The ILD is assisting in negotiating an agreement between the owners and the inhabitants for the payment by the inhabitants of the appraised value. The municipal government should be held responsible for payment to the affected owners. This case has been disputed for more than 19 years without resolution, a situation resulting in legal insecurity for both parties.

- Angeldones Arrieta

The retired persons of the Peruvian Institute of Social Security had been receiving 7,000 intis (approximately $1.00) as a special bonus. The bonus was abruptly cancelled without notification even though the amount had been paid for the previous 8 months and was established as a cost of living adjustment. This act violated labor laws which establish that any bonus is an acquired right which cannot be cancelled arbitrarily. The ILD has

so advised the Institute and is preparing to file suit if sausfaction is not obtained by the retired person.

- Informal Transport Operators

The ILD defended the informal transport operators associations against the request for an injunction blocking the presidential decree allowing informal transport operators to import duty-free tires and spare parts. The ILD defended the transport operators and made a strong case regarding the very high cost of tires produced in Peru as compared with the cost of imported tires (a ratio of nearly 2.5 : 1). The ILD won this case, which made national and international headlines.

2. Administrative Simplification Tribunal

The ILD, through its public defense lawyers, is assisting in researching the complaints filed against government bureaucrats for abuses relating to the administrative simplification act. In the first week of public complaints, six complaints were received. That number now exceeds fifty and more complaints are expected weekly. The ILD researches each of these complaints, determines which are valid and identifies the parties responsible for the bureaucratic abuse.

GLOSSARY

ABIP	"Analyses in Benefit of the Public Interest," a series of four-page magazine articles published in the early days of the ILD to summarize its research on economic issues of special importance, using numerous illustrations and photographs to catch the public's attention and communicate the message
Advocacy	The act of speaking, writing or acting in support of a cause. In the case of the ILD, advocacy includes public education on institutional reform issues, measures to obtain feedback from the public on those issues, and initiatives to disseminate the ILD's thesis to national and international audiences
Citizens' Councils	A series of special councils created under the ILD's Simplification Administrative program which are designed to receive public feedback on proposed reforms to administrative regulations and to incorporate valid suggestions into the final regulations submitted to Congress or the President for approval. Members of these councils include representatives from formal and informal businesses, labor unions, the media and government officials. Two types of councils exist: sectoral and special, the latter dealing with issues that affect more than one sector
Class Action Suit	A legal suit which seeks to defend a class of persons, as opposed to a single individual
Networking	The process of developing a group of contacts among interconnected or cooperating individuals
ODP	Officina por la Defensa Popular (Popular Defense Program), designed to provide legal defense services to selected individuals and groups from the informal sector
Public Comment	The process of allowing public participation in the review of proposed regulations prior to their finalization and enactment; public comment may be obtained through special public hearings or through written communications from citizens
Pueblos Jovenes	Shantytowns built by informals on the outskirts of Lima (literally, "young towns")

- SECTION 5 -

NATIONAL DEBUREAU-CRATIZATION PROGRAM OF BRAZIL

FEDERATIVE REPUBLIC OF BRAZIL

NATIONAL DEBUREAUCRATIZATION PROGRAM

HELIO BELTRÃO

Extraordinary Minister for Debureaucratization

April, 1982

D E B U R E A U C R A T I Z A T I O N

A N D F R E E D O M

by HELIO BELTRÃO
Extraordinary Minister for Debureaucratization

FOREWORD

In July of 1979, President João Figueiredo decided to create the National Debureaucratization Program, directly subordinated to the Presidency, under the coordination of an Extraordinary Minister. The main objective of the Program is to reverse the historical trend of the Brazilian Administration towards unnecessary growth, excessive centralization of the decision-making process, abundant regulation, rigid formalism, slowness of public services and, consequently, inefficiency. This unique and revolutionary approach to such a challenging problem has already produced impressive results. In less than 3 years, approximately 300 acts have been enacted, including laws, decree-laws, decrees, ordinances, and a series of normative decisions. All States and the most populous Municipalities have followed the Federal Government's steps and instituted local Debureaucratization programs. Four hundred million documents have been eliminated from circulation within the Federal Administration. Total cost savings, including the private and public sectors, are close to 300 billion cruzeiros (approximately US $ 2 billion) per year, amounting to about 0.8% of Brazil's annual GNP. We are confident that this is just the begining, not only of a profound reform of the Administration, but of a complete change of mentality as regards the concept of Public Service.

Helio Beltrão
Minister for Debureaucratization

TABLE OF CONTENTS

I - Debureaucratization and the democratic opening

II - The historical and cultural roots of bureaucratization in Brazil

III - Bureaucratization in private activity. Its effect on the citizen and businessman

IV - Debureaucratization and Rationalization

V - The National Debureaucratization Program

VI - Expansion of the Program's Ambit - State and Municipality — The Judiciary

VII - Administrative Decentralization and the Federation

VIII - Bureaucratization, an universal phenomenon

IX - Inflation and waste

HISTORICAL AND CULTURAL ROOTS OF BUREAUCRATIZATION IN BRAZIL

Bureaucratization is a secular trend of our Public Administratic deeply rooted in the sedimentation of habits and prejudices inherited from our colonial past and incorporated into the culture of our Public Service. We refer in particular to centralization, formalism and distrust, which are invariably present in or underlying our laws and regulations, and have become the main causes of the clogging and bureaucratization of the Brazilian Public Administration. In fact, excessive centralization of decisions and unwillingness to delegate authority have become some sort of chronic disease of our administrative body. Concentration of the decision-making power is the major reason for the regrettable slowness of services and procedures, the huge grow of the bureaucratic machinery and the progressive deflation of peripheral authority. As an aggravating factor, centralism feeds the outgrowth of an excessive central perspective which tends to apply uniform and standard solutions to an immense and heterogeneous country marked by diversities and peculiarities, claiming for different solutions for different problems.

The overattachment to formalism accounts for the absurd that the Public Administration lends more importance to the document than the fact, as if life were made of papers and not people and facts.

Finally, the mark of distrust, translated into the morbid obsession about fraud, is present in most laws, rules, and regulations which govern Public Administration and its relationsni with servants and users of public services.

Distrust in the user, servant and businessman is responsible for the landslide of requirements, formalities, approvals, certificates testimonials and other types of previous systematic and documentar evidence whose sole purpose is to make life difficult for the honest, without intimidating the dishonest individual. All this is demanded because in Public Administration, unlike in our private life, it is forbidden to believe what people say, even though it is known that they are generally stating the truth, irrespective of the fact that falsehood is a crime expressly

contemplated in the Penal Code. In Brazil, rather than punishing those who commit fraud, one is compelled to produce evidence, systematically and with documents, that he is not dishonest. Thus, the honest person is punished without inhibiting dishonesty of those who are experts in the technique of forging documents. Substantially forged documents are usually more perfect than the legitimate ones; the accounts of the dishonest persons are generally flawless as to form.

The joint influence and continued practice of these vices and prejudices wound up, throughout the years, converting Public Administration into a huge and slow, complicated and inneficient, centralized, insensitive and inhuman body. Of course, obvious and notorious exceptions must be acknowledged among organs and sectors of Government which have earned, for that reason, public recognition.

The historical truth is that Brazil was already born strictly centralized and regulated. From the very beginning, everything happened backwards.

When Tomé de Souza landed in Bahia in 1549, as Governor-General appointed by the absolutist and centralized Government of Portugal, he already brought with him a finally drafted "Statute" prepared in Lisbon, which actually was the first Brazilian Constitution. There were neither people nor society, but there was already a prefabricated administrative frame, imposed from the top and far-way, which should eventually shape both. Such model prevailed: the bureaucratic frame always preceded and conditioned social organization.

This circumstance is pointed out by all analysts of our colonization

According to João Camilo de Oliveira Torres, "the really amazing fact is that in Brazil the State has physically preceded the people". Pursuant to Oliveira Viana "the population of the local centers is already born under administrative prescriptions". This administrative and political organization is not therefore an intentional creation of individuals; it is a deformed shell brought from abroad, imported, huge, complex, heavy. According

to Faoro, "from the first century of our history, reality is made and built with decrees, charters and crown orders". Tristão de Athayde concludes: "we were a Country shaped the other way around; which had a crown before having a people; parlamentarism before elections; higher education before literacy; banks before savings".

It is not odd, therefore, that in Brazil bureaucracy has overlapped society. This was the result of the very nature of our colonization In the case of Brazil, colonization was a state undertaking, granted by the Portuguese Government to persons of trust, with the declared intent of consolidating the conquest of the territory and providing economic benefits to the Crown. No similarity whatsoever with what happened in other plans, where it was a portion of the people themselves that spontaneously emigrated with the intent to settle somewhere else, and there created their own institutions. In this latter case, it was society that invested authority. In Brazil, it was authority that founded and shaped society.

Since then Brazil has changed. It changed a great deal — and for the better — in the course of a progressive process of liberation and self-assertion. With Independence, the Empire and the Republic, profound changes took place in our political, social, and economic behavior. However, specifically in the administrative level, very little has really changed. As a result of our formalistic tradition, Brazilian bureaucracy is all written down. In other words, it has always complied with laws, decrees, regulations and ordinances, where everything is expressly and minutely regulated. Such circumstance accounts for the characteristic centralizing immobilism of our administration and the cultural gap which to this day can be observed between such behavior and the attitude of the majority of the Brazilian people.

In fact, it was mainly in Public Administration that authoritarism centralism and formalism, distrust and tutelage took shelter and grew roots, which underscore the Portuguese bureaucratic-colonial framework. And, anchored in the difficulty of changing the written rules of bureaucracy, these characteristics have been

kept substantially intact throughout the centuries, without being aware of the arrival of the republican ideals and of the concepts of citizenship and freedom proclaimed in the political level and acclaimed in the text of our successive Constitutions. Today, as in colonial Brazil, with notorious exceptions, the citizen is still treated, not as a citizen but as a subject.

III

BUREAUCRATIZATION IN PRIVATE ACTIVITY ITS EFFECTS ON ORDINARY CITIZEN AND BUSINESSMAN

The Administration has not been satisfied in growing excessively, much beyond what would be consistent with its effective social usefulness. Besides bureaucratizing itself, the Administration has been equally devoted to the task of bureaucratization of the private activity.

It goes without further evidence the fact that, in Brazil, both citizen and businessman have their daily activity growingly affected by formalities and requirements raised on their way, through excessive governmental regulation.

Distrust, formalism and the obsessive and useless concern with fraud have led the Public Administration to require from the ordinary citizen a growing number of obligations, formalities and documents without which he cannot survive, live, carry out his professional activity, support his family, register or educate his children, and bury his dead. The worker wastes a good deal of his time, and therefore his salary, running from a line to another to prove that he exists, that he is honest, that he is not lying, that he has never been involved with the police; on the top of that, he has to obtain documents which are perfectly unnecessary, created by bureaucratic routine.

As to businessman the picture is just the same. Along the years, Government interference in his daily routine has increased progressively. It is not pertinent to discuss, at this point, the

reasons — certainly sound — that have determined the creation of an endless list of Agencies, Departments, Committees or Commissions vested today with regulatory power. What must be commented is the irresistible tendency of these organs to overpass the objectives that justified their creation; in many cases they become instruments of inhibition and suffocation of the business activity. Business is pressed today by the three levels of the Federation — Federal, State and Municipal with some 500 bureaucratic, statistical, fiscal and parafiscal obligations. It is really impressive the quantity and variety of rules, forms, and requirements that businessmen are compelled to comply with. Unfortunately, the rules are frequently changed, therefore becoming still more difficult to comply with all of them. No less regretful is the practice of agencies and units ignoring one another, thereby causing businessmen to supply the same information to several different departments of the Government.

One of the express objectives of the National Debureaucratization Program is "to reduce Government interference in the activity of the citizen and the businessman, as well as to strenghten the free enterprise system". We are sincerely convinced that maintenance of free enterprise in our country depends fundamentally on the survival of small business which is, in fact, the matrix of the system. Empiric evidence has demonstrated that small business in Brazil no longer resists the burden of fiscal and bureaucratic obligations resulting from requirements forced upon it by the three levels of the Federation. Bureaucracy does not usually distinguish the big, medium and small business enterprise.

In other words, "they are all equal before bureaucracy". It so happens that the small ones, being weaker are less resistant, wind up sentenced to perish or going underground. For that reason we are assuring priority to the problems affecting small business, which, incidentally, is the great majority in the universe of Brazilian economic activity.

IV

DEBUREAUCRATIZATION AND RATIONALIZATION

Based on the above, it is obvious that "Debureaucratization" is essentially a political proposition which entails cultural change.

216

Thus, it cannot be mistaken with "Rationalization" programs which are propositions confined to the technical field, intended to increase the efficiency of Administration.

Administrative rationalization or reorganization works, even though closely related with the success of the Debureaucratization Program, are different therefrom, due to its nature and form of action.

Debureaucratizing means modifying the very structure of power and the form how it operates within the Administration. It presuposes, for that very reason, the existence of a political will, clearly stated by those who can do it. And it should forcibly be effected through the power route and not the technical route, since it means to convince and, in many instances, to compel the holders of authority to yield power and abandon the obsession to multiply controls. If we intend to facilitate the solution of matters of public interest, it is imperative to decentralize decisions, to eliminate excessive and expensive controls and assign validity to statements made by ordinary citizens and businessmen before public authorities, until evidence to the contrary. These objectives are hard to be achieved, if conducted through purely technical means. In the economic field as well, debureaucratization will not be possible without the support of power because, in this area, to debureaucratize means, above all, to deliberately reduce excessive Government interference and excessive regulation of the economic life, which overburdens and disturbs business activities, producing inflation and preventing development.

While Rationalization aims at the Administration as such, seeking to increase its efficiency and productivity, Debureaucratization addresses itself directly to the interest of the user or "consumer" of public service, with the objective of relieving him from excessive requirements, and assuring him the good service to which he is entitled. It seems out of question that the demand for good service brings about a pressure over the Administration capable of, by reflex effect, driving it to "rationalize itself".

Under these conditions, the Program is not directly concerned with the improvement of organizational charts, or the reorganization

of working flows. It seeks to reach the origins of bureaucratization and examine the institutional and normative framework that determines the behavior of the Administration. The Program seeks to revise the very text of laws, decrees and regulations, so as to eliminate therefrom the marks inherited from our colonial past.

We are obviously facing a challenge which can only be met if backed by a clear and conscientious political will to debureaucratiz the country and simplify the life of Brazilians. Such political decision was announced, from the outset, by President Figueiredo, and his unrelenting support has been decisive for the success of the Program.

THE NATIONAL DEBUREAUCRATIZATION PROGRAM

The Silent Effort of 1967

From 1967 to 1969, we undertook an intensive work towards decentralization and simplification of the federal administration machinery.

We were personally engaged in the battle of the Federal Administrativ Reform, directing the whole weight of the authority of the Ministry of Planning, which we then headed, towards that aim, and using the powers instituted by Decree nº 200, of February 25th 1967, in the elaboration of which we had previously participate by invitation of the Castello Branco Government.

The Administrative Reform of 1967 achieved important results, not sufficiently divulged yet, in the areas of decentralization of the decision-making process, organization flexibility, and indirect performance of functions. In a country where only a few were willing to yield their authority, we were able, between 1967 and 1969, to issue about twenty thousand acts of delegation of authority and a few thousand acts of reorganization aimed at providing the Administration with flexibility and agility.

However, having lost pace after 1969, the Administrative Reform never reached its ultimate and deeper objectives of simplification

and debureaucratization. In those fields, there was no time to harvest all the results of what we had extensively seeded.

Resuming Efforts

The creation of the National Debureaucratization Program, in July of 1979, under the responsibility of an Extraordinary Minister reporting to the President, undoubtedly represents a firm demonstration of the President's political will to resume and intensify the effort initiated in 1967.

During these almost three years of work, with the help of a small and dedicated staff, and the valuable support of public opinion, significant progress has been reached towards making life easier for the citizen and the businessman. Hundreds of simplifying innovations were issued through laws, decree-laws, decrees, ordinances, and other acts. Consequentely, over 400 million documents and formalities per year are already abolished. Over 3.000 acts delegation of power were signed at various levels of the Federal Administration, aimed at decentralization and acceleration of decisions.

This is more than we had expected, but very little compared with what has yet to be done. At the federal level alone, about one hundred thousand laws and decrees are in force, at present. A gigantic screening work should be performed so as to freeing many such laws and decrees from the century old marks of centralization, formalism and distrust, not to mention the hundreds of thousands of ordinances, resolutions and other normative acts.

More important than all these figures, however, is the degree of awareness that the Program is rapidly achieving. Actually, the population has approved and absorbed the objectives of the Program. The word "debureaucratization" is already in people's mind and incorporated in their day-to-day vocabulary, ;it is also present in the news and, above all, in the protests against bureaucratic excess which may be seen in lines and counters. This is the most important victory scored by the Program ;since we are before

a task whose nature does not admit final victories or instantaneous solutions. It requires much more than a single Minister and his small group of assistants; it requires much more than the duration of one Government. It is a task for at least one generation. However, even though we do not expect to defeat bureaucracy, it seems perfectly possible to check it, starting a strong and simultaneous reversing process. For progressive bureaucratization of Public Administration did not come about, as it may seem at a glance, from any deliberate purpose or from a gloomy "conspiracy of bureaucrats". It is rather, and up to a certain extent, an unconscious process whose reversion is slow and difficult,but far from impossible, if we consider that we have in our side the public opinion and the consensus of public service users. Except for some pathological cases, nobody favors bureaucracy, including the ordinary civil servant,who is the ultimate victim of the process.

Finally, it is worth pointing out the promising fact that debureaucratization is already beginning to work spontaneously. A large number of public organs are taking the initiative to simplify and speed up procedures in the benefit of a better service to the public.

Incidentally, it is our intention, in the forthcoming months, to give special attention to public handling services. In order to do so, it is imperative to enhance the administration - peripherals, namely, the levels of the administration which are today deprived of the prestige and authority enjoyed by the central ranks. Along this line, we intend to encourage the delegation of federal tasks to State organs through agreements, whenever and wherever possible and practicable.

It should be finally mentioned that, contrary to what it may seem, the Debureaucratization Program is not utopic or quixotic. It would be utopic if the bureaucratizing inheritance had been incorporated into our people's "culture". Fortunately, this did not happen. Brazilians frontally oppose bureaucracy. As we have already explained, that inheritance was confined to Public Administration, where centralization, complication, formalism and

distrust are deeply rooted; much on the contrary, Brazilians are generally simple, informal, and confident. It is not, therefore, a question of changing our people's culture, but rather one of adjusting to that culture the Public Administration behavior, which is yet bonded to an inherited and surpassed culture.

EXPANSION OF THE PROGRAM'S AMBIT

State and Municipal Governments

The Judiciary

In his aversion to bureaucracy, the ordinary citizen, who is not an expert in constitutional matters, usually ignores the borders of the Federation and the division of Powers. Bureaucracy to him is one and only one, whether Federal, State or Municipal. From the public's viewpoint, after the appointment of a Minister for Debureaucratization his authority and responsibility are without frontiers: all those affected by what the people call "bureaucracy" should appeal and complain to the Minister: slowness, complication, red-tape, excessive formalism, waste of time, insensibility, the long lines of people, rubber stamps, inconclusive decisions, thick files, unnecessary expenses. (*)

That attitude is evident in the letters received by the Minister for Debureaucratization (between 1,000 and 2,000 per month) and in complaints, brought to us through the media, where it is expected

---

(*) The Program has deliberately followed the popular or current meaning of bureaucracy, rather than the scientific or academic meaning according to which bureaucracy corresponds to a form of administrative organization, with no depreciative connotation, a concept which was specially developed by MAX WEBER (1864-1920). In as much as the Program proposes to promote a cultural change, its language, addressed directly to the user and the civil servant, cannot be the scientific language of technical books, but rather the popular language which is in people's mind. In the most up-to-date dictionaries, such as Aurélio Buarque de Holanda's, the word bureaucracy has the meaning of "complication or slowness in the performance of public service".

that the Minister should demand compliance by State and Municipal organs and the Judiciary with the norms and principles of the Program which apply only to the Federal Executive.

This behavior of the public, which is perfectly understandable, led us, from the very beginning, to the conclusion that, even though we had no authority over those organs, the Program would not have the necessary support from the public opinion, unless it were extended to State and Municipal levels. Bearing that in mind, we visited most States and the Municipalities with large population which strongly adhered to the objectives of the Program. Consequently, Debureaucratization Programs, identical to the Federal Program, have already been adopted by all States, the Federal capital, and the largest Municipalities.

As regards the Judiciary and related services, the public complains against delays and difficulties in obtaining decisions and against excessive requirements and court expenses. Of course, these matters are not comprehended within our jurisdiction.

However, the need to simplify and expedite judicial procedures does not come from ordinary citizens alone. Judges, lawyers, and jurists, directly or through the press send us strong appeals and suggestions in this connection.

Therefore, it is perfectly understandable that, acting in co-ordination with the Minister of Justice, we have been compelled to stimulate and promote debureaucratization of the Judiciary.

Like the Executive, the functioning of courts is slow, service is not satisfactory and, in several cases, formalism abounds. Judges are overloaded, lawyers waste their time meeting requirements which are merely formal; the parties suffer the disappointment and loss caused by long waits; the court servants complain that they are underpaid and overworked. Even more serious is the generalized feeling that "a bad agreement is better than a good lawsuit". This melancholic resignation of the citizen induces him to waive his rights and represents a social and political fact of the utmost gravity.

The distance between the Judiciary and the people opens the way for administrative discretion, where the destiny of the citizen is frequently found. The worst judgement is the one that is never rendered. When justice is not within the reach of the ordinary man, or is not applied reasonably fast, we cannot speak of liberty or freedom of the citizens.

The Rule of Law does not depend exclusively on improvements at the political level. The Rule of Law, above all, is manifested in the quality of the service provided to the public in the satisfaction of its rights. This is as true for the Executive as for the Judiciary.

The Debureaucratization Program which, as we have already said, falls under the ongoing process of democratic opening in Brazil, affords clear priority to solving the problems that affect those who are in greater need of assistance; unfortunately, they are still the majority of Brazilians.

Bound to this orientation, we believe that the reforms to be made in the Judiciary — and irrespective of the handling of other problems that affect the various levels and aspects of jurisdictional performance — special attention should be paid to lower instance courts, which are the front line of contact of the public with the judicial system.

We are, therefore, particularly concerned with the need to strengthen, simplify, and decentralize the lower instance courts.

It is imperative to provide, in large urban areas, a really peripheral, fast, and informal structure of local courts able to hear and judge small claims and violations, in direct contact with the parties and the witnesses. This seems the best way to bring justice closer to the people, through really summary proceedings in cases of small value, in minor litigations which are part of day-to-day life of individuals but, none the less, involve their rights as citizens.

In cities with large population and social tension, centralization of the Judiciary is, incidentally, closely related to the problem

of urban violence and the prevention of arbitrary police action. In the absence of easily accessible courts, the police tends to replace the law and the Judiciary.

We know that the improvement of lower courts falls within the jurisdiction of the States, not the Federal Government. However, the States will not be able to achieve satisfactory results unless the Federal Government opens the way, by using its constitutional authority to propose to the Congress bills concerning procedure rule: notary public, and public registries services. It seems advisable to change the procedural laws, at the Federal level, so as to enable the States to perform their part. We feel that, notwithstanding the unity principle applicable to procedure, the federal law could allow the States to choose between expressly formulated alternatives, so that State courts may be able to promote their own debureaucratization, modernization, decentralizat: and specialization. Such a change should evidently be adjusted to the local peculiarities as well as to the value, nature and complexity of the litigation.

For that purpose, we have studied and submitted to the Ministry of Justice several simplifying suggestions that resulted in some bills already sent to Congress.

Within the scope of the Ministry for Debureaucratization, a group of distinguished judges and lawyers has been operating with the active participation of representatives of the two Ministries and the Brazilian Bar Association. Several proposals have already been prepared by that Group of Jurists and converted into bills changing several provisions of the Code of Civil Procedure, with the objective of eliminating slowness factors, simplifying formalities, and releasing the judges from bureaucratic activities which do not concern specifically the judicatory activity.

From his part, the distinguished Minister of Justice has already completed the draft of a new Penal Code.

Other suggestions refer to the concern of <u>unclogging</u> the Judiciar activity, avoiding the unnecessary submission to courts of cases which permit out-of-court settlement (with the evident safeguard of court revision).

Another way of expediting jurisdictional performance in large urban centers is the creation of specialized courts. It seems convenient to stimulate the installation of decentralized Traffic courts in large cities, operating on a 24 hour basis.

This is a challenge to the creativity of judges, lawyers and jurists. And it requires the support and cooperation of the Federal and State Executive branches.

VII

ADMINISTRATIVE DECENTRALIZATION AND THE FEDERATION

The effective realization of our Federation and, very specially, the strengthening of the Municipality are closely related with successful achievement of the Program's goals.

The President's commitment towards municipalism is absolutely clear: "We want strong and prosperous Brazilian Municipalities. I am determined to achieve that objective. The Municipality is the first step to our political and administrative organization. It should also be the first community agent of democracy, economic development, social justice and institutional stability".

However, for the full achievement of the President's commitment there is a long way to go. Seventy percent of the 4,000 Brazilian Municipalities have less than 20,000 inhabitants and are deprived of minimum material and human resources to perform their role.

The overwhelming majority of the Municipalities is suffering from serious lack of financial resources. The revenue of 95% of them comes mainly from resources transferred from the Federal Government which represent, in average, 70% of its budget.

The overall participation of the 4,000 Brazilian Municipalities in the Government revenue is rather small. Such a participation, even though it has gradually increased, still represents, in terms of total taxes collected, less than 6%, a percentage which reaches about 16% upon computation of the Federal and State transfers.

Unfortunately, the effective participation of the Municipalities in the analysis and solution of problems closely related with local communities is even smaller. Since there is no clear legal definition of the tasks that sould be performed by each of the three levels of the Federation, and as a result of excessive centralism, the Municipalities, in most cases, practically do not participate in the solution of the serious problems that anguish the day-to-day life of the citizen. I am talking, among others, about the basic problems of nourishment, health, education, housing, which frequently assume dramatic aspects. Throughout the years, the solution of these problems has been left to other levels of the Federation, specially the Federal Government, with the consequent deflation of local authority. However, the Mayor is the person who directly suffers the pressure and the burden of popular dissatisfaction. Precisely him, the Mayor, who usually has neither the resources nor effective participation in the solution of the problems of his community.

This situation must change radically, if, in fact, we want to revitalize the Brazilian society and give adequate support to the solution of national problems.

As we said recently, "the great change to be made in this country is to fight excessive bureaucratic centralism, which is the most serious internal drawback to our aspirations of social, economic, and political development."

We are convinced that, as long as we do not enforce administrative decentralization, there will be no Federation in this country. As long as we do not decentralize decisions and utilization of resources, the autonomy of States and Municipalities will continue to represent a much more formal than real concept.

In order to initiate that decentralization, it is not necessary to wait for a constitutional amendment. It is required, in fact, a courageous political decision of the Federal Government, in the sense of voluntarily reducing its field of direct performance, and gradually increase, through agreements and other legal means the utilization of State and Municipal services, as well as the v of resources at their disposal. That political decision has already

been taken by President Figueiredo.

By virtue of our condition of a historically unitarian country, as a result of lack of tradition of autonomy of local governments, and in the absence of local concern with the need to meet the major requirements of our development, the Constitution provided the Federal Government with broad legislative and taxation powers. But this sould not obst the much desired decentralization of resources and decisions. All depends on how the Federal Government utilizes its constitutional competence. The federal competence to regulate certain matters or collect certain taxes does not mean that the performance of all tasks or the application of all resources should be the exclusively incumbent upon the Federal Administration. Unfortunately, what we have seen throughout the years was the Federa Government claiming, gradually and unconsciously, the administration of almost all matters, invading the undeniable authority of local governments to regulate problems of their immediate interest.

In short, progressive Federalization of all problems took place in Brazil, and competence to legislate was confused with exclusive authority to perform.

The administ tive decentralization is perfectly compatible with the national approach to certain problems which, due to their nature or dimension, require the programming and coordination of the Federal Government.

However, national is not a synonym of central.

The fact that there is a national policy for a certain matter does not mean that the enforcement thereof should be left exclusively to the Federal Administration, nor that the application of resources should be centralized in its hands. Moreover, it does not mean that all aspects of national interest should be defined in federal law. The federal legislator, using common sense, must recognize the existence of regional differences and local peculiariti and, consequently, should limit himself to the more general rules, thereby leaving space to State or Municipal authorities to regulate and manage enforcement details.

Decentralization is, in fact, the best manner of assuring efficiency and reduction of cost of federal programs. No natior planning can be really efficient unless its execution is widely decentralized, and, since its inception stage, the participation of local administrative mechanisms is engaged; for they are naturally better qualified, in each concrete case, to identify and solve problems in a more readily and specific manner.

It is clear that this concept does not apply to the configuration and solution of supra-local problems or to the organization of large industrial units, as, for instance, in sectors such as electric power, petroleum, communications, steel, railways, main highways, and other sectors predominantly under federal responsibility. Nevertheless, aside from these cases, it is unjustifiable, in countries with characteristics such as ours, to exclude local participation from matters which, although governed by federal law,pertain to day-to-day interest of the citizen. Furthermore, it is not reasonable that peculiar and urgent problems should fall within the sole responsibility of distant, centralized, heavy and standardized federal organs.

One vigorous step towards fighting bureaucratic centralization and strenghtening local governments was taken by President Figueiredo when he simplified the transfer of funds,collected by the Federal Government,to the States and Municipalities. Said funds, which frequently awaited more than six months to reach their destination, are now being transferred almost automatically, after the elimination of compulsory presentation of investment plans and other unjustified control mechanisms — a form of tutelage previously exercised by the Federal Government over the applicatio and transfer of funds.

Since most Municipalities not even have an accountant or qualified professional to fill out all forms and comply with all bureaucratic requirements imposed by federal agencies, they usually hire "despachantes" (professional expediters) and sometimes rely on agents and specialized offices to accelerate the releasing of funds.

With the enactment of Decree-Laws nº 1.805, of October 1, 1980, and nº 1.833, of December 23, 1980, the President released local governments from federal tutelage and from the obligation to observe theoretical percentages applicable to expenditure or investment. Furthermore, it was specifically determined that local governments shall decide on how and where to invest these funds. Mistakes or abuses will be judged by the community itself, and inspected by the State Auditing Court or Municipal Auditing Councils.

We are proud of having contributed to such courageous step which, in President Figueiredo's words, "is neither a complete solution for resolving the problem of the fragility of the Federation, nor for the lack of municipal resources. But it is a major first step, among others which will follow within the same philosophy."

VIII

BUREAUCRATIZATION, UNIVERSAL PHENOMENON

Bureaucratization is not a Brazilian privilege. It exists, to a greater or smaller degree, in all countries and, in many of them, it has become a growing concern. The Program, incidentally has aroused interest outside of Brazil and deserved reasonable space and generous references in important foreign newspapers.

Nor is bureaucratization an exclusive problem of Public Administration; it can be equally found in large private companies.

Bureaucratization is actually a phenomenon closely associated to dimension. Once it reaches a certain size, every organism tends to become bureaucratized. It so happens that growth causes the loss of the human dimension. Personal contact is substituted by written communication. Man or woman changes from subject to object; from master of decision to slave of regulations. Personal leadership melts away in the procedural manuals. Individual and peculiar decisions, adjusted to the reality of each case, is replaced by standardization and uniformity of decisions. The organization cools off: it loses warmth, punch, motivation, sense of urgency and direction; it becomes insensitive and slow. In short, it bureaucratizes itself.

This is essentially true for both State owned as well as large private companies. Having managed both, I had to fight against the bureacratization trend in either case. This is also true with respect to both national and foreign companies.

To debureaucratize means, essentially, to decentralize authority and, simultaneously, to revitalize and expedite the administrative body, through the freeing of man's iniciative and creative effort.

IX

INFLATION AND WASTE

What we are trying to do through our crusade is to induce Brazilians and the Public Administration to rediscover Brazil and to land in our reality. In order to reach that objective, it will be necessary to waive excessive sophistication and restore the esteem for simple, wise, and inexpensive solutions adjusted to our regional peculiarities, and, above all, to the low standard of living of the majority of our people. This is the only way which will enable us to reduce the considerable waste rate inherent to our magnificent structures and complicated bureaucrati procedures, as well as to the splendor of our public buildings and to the implementation of non-essential investments. The waste and excessive cost of our bureaucratic machinery are two powerful sources of inflation in Brazil.

DECREE 83.740, OF JULY 18, 1979

DECREE Nº 83.740, OF JULY 18, 1979.

(Instituting the National Debureaucratization Program)

The PRESIDENT OF THE REPUBLIC, using the authority granted pursuant to article 81, item III, of the Constitution, hereby decrees:

Art.1 The National Debureaucratization Program, aiming at the dynamization and simplification of the Federal Administration, is hereby instituted.

Art.2 The National Debureaucratization Program shall be directly subordinated to the President of the Republic with the assistance of a Extraordinary Minister, who shall direct and coordinate the implementation of the Program pursuant to the provisions of this Decree.

Art.3 The objectives of the Program are the following:

a) to contribute to the improvement of the quality of services rendered to the public by the Federal Administration;

b) to reduce the interference of the Government in the activities of ordinary citizens and businessmen and expedite the solution of cases where said interference is required, by means of decentralization of decisions, simplification of administrative work, and elimination of formalities and requirements whose economic or social cost exceedes the risks involved;

c) to expedite the implementation of federal programs in order to ensure the achievement of the main objectives established by the Government;

d) to replace, whenever feasible, prior controls by the efficient supervision of performance and by reinforcement of directed inspection in order to identify and correct deviations frauds and abuses;

e) to intensify the implementation of the Administrati

Reform contemplated in Decree nº 200, of February 25,1967, particularly in connection with the matters dealt with in Title XIII thereof;

f) to strenghten the free enterprise system by means of assistance to small and medium size business enterprises, which constitute the matrix of said system, and by consolidation of large domestic companies in order to permit them to assume, whenever possible, the attributions and functions which are, at present, under the responsability of State companies;

g) to stall the unnecessary growth of the federal bureaucracy by stimulating the indirect execution of administrative tasks through contracts with qualified private companies and agreements with State and Municipal governmental agencies;

h) to oversee compliance with the policy of containment in the creation of State companies, and, whenever possible and advisable, promote the transfer of control of said companies to the private sector, pursuant to the directives set forth by the Government in this connection.

Art.4 For the adequate performance of this function, the Extraordinary Minister for Debureaucratization shall:

a) integrate the structure of the Presidency and operate in close coordination with the Office of the Presidency's Cabinet and the Ministries of Planning and Social Communication which shall provide the necessary support to the Minister for Debureaucratization;

b) promote, in cooperation with the other Ministers, the urgent enforcement by their respective Ministries of measures necessary to achieve the Program's objectives, undertaking for that purpose the revision and adjustment of laws, regulations and ordinances in force;

c) directly contact State and Municipal authorities in connection with the adoption of measures which, although comprehended within the ambit of the Program, are outside federal jurisdiction;

d) whenever requested, cooperate with the Judiciary and the Legislative, including through examination and analysi of recommendations which involve the iniciative of the Executi. and

e) recommend to the President the adoption of all measures which he deems necessary to the effective enforcement of this Decree.

Art.5 This Decree shall come into force on the date of its publication, and all dispositions to the contrary are hereby revoked.

Brasília, July 18, 1979.

JOÃO FIGUEIREDO
President of the Republic

MAIN ACTS

DEBUREAUCRATIZATION - MAIN ACTS

1. The National Debureaucratization Program was established on July 18, 1979, by Presidential Decree nº 83.740. The main objectives of the Program, as defined in said Decree, are the following:

a) to help improving the quality of services rendered to the public within the Federal Administration;

b) to reduce Government interference in the activities of businessmen and ordinary citizens and limit to a minimum the number of cases where this interference is necessary, through the decentralization of the decision-making process, the simplification of the administrative work, and the elimination of formalities and requirements whose economic or social cost are excessive in relation to the risk involved;

c) to speed up the execution of federal programs in order to guarantee the fulfillment of the main objectives of the Government;

d) to replace, whenever possible, previous control by the efficient surveillance of performance and the strengthenin of directed control aiming at the identification and correction of eventual deviations, frauds and abuses;

---

*) The term "Federal Administration" shall be hereinafter referred to as including Direct and Indirect Federal Administratition Agencies and Units. Indirect Administration comprises Federal Autarchies, Federally Controlled Companies and Foundations.

e) to intensify the implementation of the Administrative Reform, in conformity with Decree-Law nº 200, of February 25, 1967;

f) to strengthen the free enterprise system, by favoring the small and medium size firms, which constitute the matrix of said system, and by consolidating large private Brazilian companies in order to prepare them, when necessary, to assume tasks and functions which are presently under the responsibility of State companies;

g) to prevent unnecessary growth of the federal administrative machinery, by stimulating whenever possible, the indirect performance of funtions through contracts with qualified private companies and agreements with State and Municipal agencies;

h) to oversee the policy of containment of indiscriminate creation of State companies, and whenever feasible and advisable, promote the transfer of control of said companies to the private sector, within the Government guidelines on this matter. (Decree nº 83.740, of July 18, 1979).

2. Debts of any kind owed to the National Treasury, of an original amount equal to or less than Cr$ 1.000,00 (one thousand cruzeiros), registered as "public debt" until December 31, 1978, are cancelled, and the respective administrative procedures are closed (Decree-Law nº 1.687, of July 18, 1979).

Note: This limit was increased from Cr$ 1.000,00 to Cr$ 3.000,00 (three thousand cruzeiros).

3. Cancellation of debts concerning:

a - Income Tax;

b - Taxes on Industrialized Products - IPI;

c - Importation Tax;

d - Fines of any sort provided for in law; and

e - Judicial costs

of an amount equal to or less than Cr$ 1.000,00, up to December 31, 1978, not yet registered as public debt.

Note: This limit was increased from Cr$ 1.000,00 to Cr$ 3.000,00 by Decree-Law nº 1.736, of July 18, 1979).

4. Intensification of decentralization of decisions through redefinition or delegation of authority in the various levels is recommended, in order to free the central structure of the Federal Administration from merely formal administrative tasks and to grant to local agencies or employees, at operational level, authority to decide individual cases, except those reserved for central decision. (Decree nº 83.785, of July 30, 1979).

5. Waiver of routine hearing of technical departments is recommended in proceedings referring to matters

where no controversy is involved or where a decision of a normative character already exists. (Decree nº 83.785, of July 30, 1979).

6. Waiver of routine referral to legal departments is recommended, except for those matters that involve new legal issues, such as a legal matter which has not received any previous opinion from said departments. (Decree nº 83.785, of July 30, 1979).

7. Compulsory circulation of documents and applications by general registries ("protocolos") is abolished. The matters will be, whenever possible, directly sent to the competent unit to be studied and resolved (Decree nº 83.785, of July 30, 1979).

8. Direct comunication and free exchange of information between units and departments, without the need forintermediary circulation through higher authorities, is authorized. (Decree nº 83.785, of July 30, 1979).

9./12. Authority is delegated to the Ministers of State to perform, subject to applicable legal provisions, the following acts regarding public employees: fulfillment of jobs or positions; entrance requirements (nomination); promotion; deployment (within the Ministry); resignation or dismissal; and retirement.

16. Authority is delegated to the General Director of DASP to perform, subject to applicable legal provisions with respect to the civil servants of Federal Administration the following acts: employment; redistribution; and utilization, in another Ministry or Autonomous Agencies. (Decree nº 83.840, of August 14, 1979).

17. Authority is delegated to the Minister of Mines and Energy to grant concession of mining or declare its termination, subject to applicable legal provisions. (Decree nº 83.841, of August 14, 1979).

18. Authority is delegated to the Minister of Labor to grant, subject to applicable legal provisions, permission for the functioning of business on Sundays and civil or religious holidays (Decree nº 83.842, of August 14, 1979).

19. Authority is delegated to the Minister of Finance to authorize the assignment of the use of Government property, subject to applicable legal provisions. (Decree nº 83.943, of August 14, 1979).

20. Authority is delegated to the Minister of Finance to aprove transactions and authorize contracts referred to in Articles 1st and 8th of Decree-Law nº 1.312, of February 15, 1974 (to provide garanty of the National Treasury to financial operations entered abroad and to enter into loan agreements in foreign currency) (Decree nº 83.856, of August 15, 1979).

(Decree nº 83.840, of August 14, 1979).

13. Authority is delegated to the Chief of the Presidential Cabinet to perform, in accordance with applicable legal provisions, the following acts:

a) to waive the proof of attendance to work by civil servants of the Federal Administration;

b) to authorize the travelling abroad, contemplated in Article 3, of Decree nº 74.143, of June 4, 1974, except when expenses are paid by the Treasury, in which case prior and express authorization from the President of the Republic is required. (Decree nº 83.840, of August 14, 1979).

14. Authority is delegated to the Counsel General of the Republic to perform, subject to applicable legal provisions, the following acts regarding civil servants of the Counsel General's office: fulfillment of jobs or functions, entrance position requirements (nomination), promotions, deployment, resignation or dismissal, and retirement (Decree nº 83.840, of August 14, 1979).

15. Authority is delegated to the General Director of "DASP" (Civil Service Dpt.) to perform, subject to applicable legal provisions, the following acts regarding its own employees: fulfillment of jobs or positions, requeriments for hiring, promoting, firing, resignation and retirement (Decree nº 83.840, of August 14, 1979).

21. Authority is delegated to the Minister of Education and Culture, subject to applicable legal provisions, after the approval of the Federal Council of Education or, when necessary, the competent State Council of Education, to perform the following acts:

a - grant recognition and authorize the conversion of higher level courses;

b - approve the charters of universities and educational establishments of advanced levels. (Decree nº 83.857, of August 15, 1979).

22. Photograph on temporary Driver's Licence is abolished. (Decree nº 83.863, of August 16, 1979).

23. Authority to change format of documents referred to in the National Traffic Code, including driver's licence, was given to the National Traffic Council, subject to the approval of the Minister of Justice (Decree nº 83.863, of August 16, 1979).

24. Authority is delegated to the Minister of Finance, subject to applicable legal provisions, to authorize registration of Government's real property. (Decree nº 83.869, of August 20, 1979).

25. Debts of any sort to federal autonomous agencies, equal to or less than Cr$ 1.000,00, up to December 31, 1978, whether or not registered as public debt, are cancelled, and the respective administrative proceedings are closed. Judicial proceedings to collect said de debts are to be closed by the Judge. (Decree-Law nº 1.964, of September 6, 1979).

26. Assumption of truth must prevail in the relationship between the Federal Administration and its employees or with the public in general; said principle consisting in believing that people are telling the truth until evidence to the contrary. (Decree nº 83.936, of September 6, 1979).

27. Requirement for presentation of the following certificates is abolished in the Federal Administration:

a - life certificate;
b - residence certificate;
c - poverty certificate;
d - economic dependency certificate;
e - certificate of moral reliability;
f - certificate of negative criminal record.

In lieu of said documents a declaration of the interested party or his legal representative will be accepted. (Decree nº 83.936, of September 6, 1979).

28. Requirement of presentation of any document in its original form is abolished except when especifically required by law. An authenticated or notarized copy will be accepted instead. (Decree nº 83.936, of September 6, 1979).

29. Authentication of copy of a document may be effected by the public employee to whom it is presented through comparison with the original document which is to be returned to the interested party. (Decree nº 83.936, of September 6, 1979).

30. Nobody shall be required to prove a fact which has been already proved by the presentation of another valid document. (Decree nº 83.936, of September 6, 1979).

31. Communication between Federal Administration Agencies or Units and the interested parties is authorized by any means: oral communication, directly or by telephone, mail, cable or telex. When necessary, the circumstance shall be recorded by the Agency or Unit in the files. (Decree nº 83.036, of September 6, 1979).

32. Delegation of authority is widely admitted at the option of the delegating authority. The delegated authority shall be clearly mentioned in the act of delegation. The period of validity shall be considered undetermined unless expressely stated in the delegation act.

Delegation is granted to the position, or function and not to its occupant; therefore, change of the occupant will not cause termination of the delegated authority (Decree nº 83.937, of September 6, 1979).

33. Delegation of authority to a position or function not directly subordinated to the delegating authority is permitted. (Decree nº 83.037, of September 6, 1979).

34. The incorporation of acts of delegation in the internal regulations of the Agency or Unit is encouraged (Decree nº 83.937, of September 6, 1979).

35. Provisions of decrees, regulations, or normative acts of Federal Administration which prohibit subdelegati of anthority are cancelled. The act of delegating presuposes the authority to subdelegate. (Decree nº 83.937, of September 6, 1979).

36. No document shall be required for the renewal of driver's licenses after periodic medical examination: photograph, signature of holder and taxpayer number of registration are abolished in driver's licences. (Resolution nº 553, of September 18, 1979), of the National Traffic Council).

37. Authority is delegated to the Minister of Finance to either accept or refuse the donation of properties

to the Government, subject to the Civil Code and other applicable legal provisions (Decree nº 84.045, of October 2, 1979).

38. The presentation of the Taxpayer Card (CIC) or the indication of the number of registration in the Taxpayer Personal Registry (CPF) shall be required only in connection with the following hypotheses:

a) income tax return;
b) taxpayers subject to withgolding tax;
c) liberal professionals, i.e. those self-employed required to register in professional supervising entities;
d) individuals who let property;
e) participants in real estate operations, including collaterals, of any sum superior to 1.000 UPC (Indexed Capital Units)
f) other cases as defined by the Minister of Finance (Decrre nº 84.047, of October 2, 1979).

39. Registration in the Taxpayer Personal Registry (CPF) is not required from the following persons with fiscal domicil abroad:

a) individuals whose incomes are subject to witholding tax;
b) liberal professionals, understood to mean those required to register in professional supervising entities.

c) individuals who let property;

d) participants in real estate operations, including collaterals, of any sum superior to 1.000 UPC (Indexed Capital Unities).

(Decree nº 84.047, of October 2, 1979).

40. The annual submission of a nominal Employees Report, (the so-called "2/3 law"), provided for in Article 360 of the Consolidated Labor Code (CLT) is abolished, based on the fact that said information is already provided in the Annual Report of Social Informations (RAIS), established by Decree nº 76.900, of December 23, 1979.

41. Ample publicity by the Ministries of Decrees and other acts issued within the Deburocratization Program is recommended by the President through the Chief of the President's Cabinet. (Ordinance nº 09, of October 8, 1979).

42. Debts of any sort to Social Security and those related with contributions due to third parties and collected by the Financial Administration Institute for Social Security (IAPAS) of any sum equal to or less than Cr$ 3.000,00, constituted until September 30, 1979, are cancelled and the respective administrative processes are closed. Judicial proceedings for collection of said debts will be closed by the Judge. (Decree-Law nº 1.699, of October 16, 1979).

43. Debts to Social Security, of any sum equal to or less than Cr$ 3.000,00 constituted until September 30, 1979, related to real estate transactions, are cancelled. (Decree-Law nº 1.699, of October 16, 1979).

44. Debts to Social Security, of any sum equal to or less than Cr$ 3.000,00, constituted until September 30, 1979, related to letting of property, are cancelled, provided that the debtor vacated the property prior to December 31, 1979). (Decree-Law nº 1.699, of October 16, 1979).

45. Debts to Social Security, of any sum equal to or less than Cr$ 3.000,00, constituted until September 30, 1979, of former employees who have died, or whose whereabouts are unknown, are cancelled. (Decree-Law nº 1.699, of October 16, 1979).

46. Debts to Social Security, of any sum equal to or less than Cr$ 3.000,00, originated from contracts for the rendering of services rescinded up to December 31, 1979, are cancelled. (Decree-Law nº 1.699, of October 16, 1979).

47. Debts of any sum to Social Security related to financing for the purchase of trucks, granted by the now extinct Social Security Institute for Transportation Employees (IAPETC) are cancelled. (Decree-Law nº 1.699, of October 16, 1979).

48. The compulsory registration of bills of change and promissory notes established in article 2 and its paragraphs of Decree-Law nº 427, of January 22, 1969, and Article 1st paragraph 11, of Decree-Law nº 1.042, of October 21, 1969, is revoked(Decree-Law nº 1.700, of October 18, 1979).

49. Prior evidence of registration in the General Taxpayer Registry (CGC), as a condition for filing in the Business Registry acts related to the organization, alteration or termination of firms and corporations,is abolished, as well as for approval and delivery of the respective documents to the interested parties. The registration, alteration or termination in the CGC will be effected simultaneously with the corresponding acts in the Business Registry. Consequently, the parties no longer need to appear personally before the Revenue Agency.(Decree nº 84.101, of October 18, 1979).

50. Payment of corporate income tax based on assumed profits is extended to companies with total annual income equal to or less than 100.000 ORTN(Reajustable Treasury Bonds).

51. Simplification of procedures in the Business Registry is determined, based on the principle of presumption of truth, reducion of documentary evidence and acceleration of services in general. (Directive nº 4, of November 8,1979, of the National Department of Business Registry).

52. All Agencies and Units of the Federal Administration are prohibited from requiring good standing certificates regarding taxes, fines, and other fiscal charges, except in the following cases:

a) declaration of bankruptcy and judicial extinction of debtor's obligations;

b) entering into contract with any Unit of the Federal Administration or Autonomous Agencies, as well as participation in public tenders promoted by said Units and Agencies;

c) transfer of residence to abroad;

d) selling of commercial or industrial establishments by public auction;

e) filing in the Public Registry of acts of extinction of companies, or other acts amounting to reduction of capital, except in case of bankruptcy;

f) other cases to be established by the Executive. (Decree-Law nº 1.715, of November 22, 1979).

53. The declaration of "contumacious debtor to the Treasury" is abolished. (Decree-Law nº 1.715, of November 22, 1979).

54. The National Department of Business Registry and Business Registration Boards are no longer required to send to the Revenue Agency copies of registered documents referring to contracts, alterations, and termination of companies and fir (Decree-Law nº 1.718, of November 27, 1979).

55. Federal, State and Municipal Administration Units are no longer required to demand from their employees evidence of having filed their income tax returns as a condition for the payment of salaries. (Decree-Law nº 1.718, of November 27, 1979).

56. Federal, State and Municipal Administration Units that pay interest on registered public bonds are no longer required to annually report the transfer of bonds occurred in the previous year. (Decree-Law nº 1.718, of November 27, 1979).

57. Notary Public, Real Estate Registries, Bonds and Documents Registries, Judicial Notaries, and Maritime Mortgage Registries are no longer required to report to the Revenue Agency information of vaious nature contemplated in the Income Tax Legislation (Decree-Law nº 1.718, of November 27, 1979).

58. The National Institute of Patents and Trademarks (INPI) is no longer required to supply to the Revenue Agency information on registration of patents and industrial or commercial trademarks (Decree-Law nº 1.718, of November 24, 1979).

59. The supply to the Revenue Agency of annual information by persons who in the normal course of business are entrusted with receiving interest, except for public debts, yielding from the purchase and sale of stocks and bonds and exchance transaction on behalf of clients, is no longer required. (Decree-Law nº 1.718, of November 27, 1979).

60. Insurance companies are no longer required to supply the Revenue Agency with annual information on pension payments. (Decree-Law nº 1.718, of November 27, 1979).

61. Entities that make copyright payments are no longer required to inform annually to the Revenue Agency the amount of income paid. (Decree-Law nº 1.718, of November 27, 1979).

62. Financial institutions are not longer required to inform the Revenue Agency about interests paid or credited when the sum is superior to Cr$ 400,00; said requirement will be complied with pursuant to the general principles concerning information on incomes paid. (Decree-Law nº 1.718, of November 27, 1979).

63. The Caixa Econômica Federal (Savings Federal Agency) and other public credit establishments are no longer prohibited from accepting as a loan collateral assets of a value superior to the one mentioned in the annual declaration of assets filed by the borrower before the Revenue Agency. (Decree-Law nº 1.718, of November 27, 1979).

64. The system of sample luggage checking in customs is established in the International Airports of Rio de Janeiro, São Paulo, Viracopos (SP) and Manaus (AM).

65. The number of documents required from applicants willing to acquire residential units under the Federal Housing Financial System, through loans equal to or less than 1.500 UPC (Indexed Capital Units) is drastically reduced. Only the Identification Card, the labor card and salary statement, together with a Social-Economic declaration, may be demanded from the applicant to support his application. (Law nº 6.748, of December 10, 1979).

66. The certificate of utilization of Fiscal Incentives (CAIF), previously issued by the Revenue Agency in accordance with Article 15, of Decree-Law nº 1.376, of December 12, 1979, is abolished (Decree-Law nº 1.752, of December 31, 1979).

67. The annual submission of the "Relação de Menores" (Report on employees under 21) is abolished, since the Annual Social Information Report (RAIS), regulated by Decree 76.900, of December 23, 1975, is sufficient for that purpose. Companies are no longer required to present the form approved by the Directive nº 5 of January 21, 1944. (Directive nº 3.007, January 7, 1980, of the Minister of Labor).

68. Prior approval from DASP (Civil Service Department) for acquisition and/or transfer of vehicles is dispensed with, subject to general rules and provisions applicable to the matter. (Directive nº 114, January 14, 1980, of DASP).

69. Informations to DASP concerning bids and contracts for cleaning, maintenance and,security services are simplified. (Directive nº 115, January 17, 1980, of DASP).

70. Applications by Federal Administration employees are no longer required for the granting of:

a - disability benefits;

b - employment bonus;

c - expense allowances;

d - vacations

(Decree nº 84.414, of January 23, 1980).

71. Applications are no longer required for the cancellation of family allowance payments and renewal of special leaves of absence, as well as the requirement that such leaves, when for a period of less than six months, should start and finish in the same year. (Decree nº 84.414, of January 23, 1980).

72. The requirement of "Certidões de Tempo de Serviço" (Certificates of Lenght of Service), to be included in the retirement proceedings, is abolished (Decree nº 84.440, of January 29, 1980).

73. Authenticated copies of notarial acts perform before Brazilian Consulates are deemed valid when signed by the Consular Authority. (Decree nº 85.451, of January 31, 1980).

74. Official documents issued by foreign authorities, to be effective in Brazil, no longer need consular legalization, as long as they are sent through diplomatic channels from the foreign Government to the Brazilian Government. (Decree nº 84.451, of January 31, 1980).

75. Signatures of Brazilian consular authorities are valid in documents of any type all over the country, without the need of previons notarization. (Decree nº 85.451, of January 31, 1980).

76. Authority is delegated to the Minister of Foreign Affairs to approve and modify regulations on the Honorary Consular Services. (Decree nº 84.455, of January 31, 1980).

77. Procedures for disposition of useless material, i.e., obsolete or damaged material or of expensive recovery or precarious efficiency, are simplified and decentralized (Directive nº 116, of February 25, 1980, DASP).

78. The issuing of passports is simplified and their time of validity is increased from 4 to 6 years. (Decree nº 84.541, of March 11, 1980).

79. The requirement for an exit visa for Brazilian citizens is abolished. (Decree nº 84.541, of March 11, 1980).

80. The filling out of the Register of Hotel Guests Form (Ficha Nacional de Registro de Hóspedes) is simplified. Information of purely statistic nature are no longer required in this connection. (Decree nº 84.541, of March 11, 1980).

81. The Diário Oficial (Official Gazzette) is redesigned with the aim of accelerating its distribution, reducing costs and subscription prices for the reader's convenience. "Diário Oficial" is to circulate in the date of publication. (Decree nº 84.555, of March 12, 1980).

82. Questions addressed to any Agency or Unit of the Federal Administration by the Extraordinary Minister for Debureaucratization will be treated as urgent and with priority and shall be answered by the Agency or Unit directly to said Minister. (Decree nº 84.585, of March 24, 1980).

83. In case of non-compliance with laws and decrees as, for instance, with respect to bureaucratic requirements already abolished, the Agency or Unit will immediately correct its action, reporting thereafter the occurrence to the authority to which it is subordinated. (Decree nº 84.585, of March 24, 1980).

84. A fine to be applied by the "Banco Nacional da Habitação" (Housing National Bank), in cases of non-complianc with the provisions of Law nº 6.748, of December 10, 1979, that reduced the number of documents required from applicants wishing

to acquire residential units under the "Sistema Financeiro da Habitação" (Housing Financing System), is instituted. (Resolution 61/80, of March 24, 1980).

85. Agents acting on behalf of retired employes or beneficiaries are no longer required to present to the Ministry of Finance half-yearly life certificates attesting that the principal is alive, nor to submit a new proxy executed before a Notary Public. A declaration of the Agent stating that the principal is alive will be sufficient to receive pension payments. (Directive nº 189, March 26, 1980, of the Minister of Finance).

86. Companies and firms are exempt from income tax when their annual gross sales are equal to or less than 3.000 (three thousand) ORTN (Readjustable Treasury Bonds), beginning, in fiscal year 1981. (Decree-Law nº 1.780, of April 14, 1980). The exemption, designed to favor small business, covers about 60% of income tax regular corporation returns)

87. Companies and firms exempt from income tax as above are no longer required to keep accounting records related to income tax as well as to effect monetary correction on permanent and net assets. (Decree-Law nº 1.780, of April 14, 1980).

88. Rates of Industrial Products Tax (IPI), for products classified in the index approved by the Decree nº 84.338, of December 26, 1979 (products typical of small businesses), are reduced to zero. (Decree nº 84.634, of April 14, 1980).

89. A simplified model of the work timetable ("Quadro de Horário"), as provided in Article 74 of the Consolidated Labor Code, is approved. (Directive 3.088, of April 28, 1980, of the Minister of Labor).

90. The evidence of legal capacity and tax good standing, required from firms and companies as a condition to participate in public bids promoted by the Federal Administration for purchases, works and services is drastically simplified through the introduction of a "CRJF - Certificado de Regularidade Jurídico-Fiscal" (Certificate of Legal capacity and Tax Good Standing). (Decree nº 84.701, of May 13, 1980).

91. The requirement of evidence of payment of taxes, annuities and social obligations, within the Federal area, is substantially simplified. (Decree nº 84.702, of May 13, 1980).

92. Federal Administration Agencies and Units are forbidden:

a) to refuse acceptance of evidence made through public certificates, if the certifcate has been issued for other specific purpose;

b) to require the presentation of documents in the original form;

c) to deny validity to documents presented by authenticated copy;

d) to retain the original document, when presented together with its copy for purposes of authentication.

93. Accounting related with proper utilization of goods imported with tax benefits may be effected manually, mencanically or by electronic means. (Declaratory Norm CST 15, May 15, 1980..

94. Documents to be presented by employees and individuals to the Ministry of Labor may be mailed through the ECT (Post Office). (Directive nº 3.120, of May 19, 1980, of the Minister of Labor).

95. Ships arriving from abroad are no longer required to present negative certificate of cargo from ports of scale in Brazil or abroad (Norm CST 16, May 22, 1980).

96. Non-profitable organization exempt from income tax (education or social assistance institutions, trade unions, associations and foundations of charitable, artistic, literary or recreational character) are no longer required to file income tax returns or an Exemption Certificate. These entities

will annually present a simplified statement of exemption (Directive nº 071, June 18, 1980, of the Revenue Agency).

97. The new form of Income Tax Exemption Statement replaces the request for official previous recognition of exemption. (Directive SRF 071, June 18, 1980, of the Revenue Agency).

98. The requirement of presentation of a document signed by a physician, as a condition to receive birthallowance from the INPS (Social Security Agency), has been suspended. Presentation of Birth Certificate will be sufficient (Directive nº 248, of June 19, 1980).

99. Licence for non professional fishing is simplified, and a new simplified model of "Guia de Recolhimento" (Payment Form), for permitting amateur fishing, has been adopted and shall be accepted as evidence of regularity of amateur fishing all over the country, (SUDEPE - Fishing Development Department - Order nº 01/80).

100. The Executive branch is authorized to refrain from initiating judicial proceedings for collection of debts to the Treasury and Federal Agencies when the value to be collect is not higher than 20 ORTN (Readjustable Treasury Bonds), except in connection with writs of mandamus and expropriation lawsuits. (Decree-Law nº 1.793, June 23, 1980).

101. Authority is delegated to the Minister of Foreign Affairs to approve, under special circumstances, the marriage of diplomats to foreign citizens, in accordance with Article 1, of Law 5.887, of May 31, 1973 (Decree nº 84.870, of July 2, 1980).

102. The Program of Bibliographic Commutation (COMUT) is instituted in the Ministry of Education with the following purpose:

a) to facilitate access to existing documents;

b) to reduce bureaucratic obstacles in connection with the acquisition of copies of documents;

c) to decentralize, expedite and assure reliability of services;

d) to centralize financial operations with the purpose of reducind costs.

103. A Special Committee is organized in the Ministry of Justice with the purpose of promoting the publication of up-to-date compilations of sparse legislation and, subsequently, its consolidation. (Decree 85.022, of August 11, 1980).

104. The CECTA - Special Registry of Payers of Customs Duties) is abolished. Information on imports and exports will be supplied by the Taxpayers General Registry. (Norm SRF 091, of August 27, 1980, of the Revenue Agency).

105. A simplified taxation system for charging import duties on "Colis Postaux" remittances is established; the Minister of Finance is authorized to define procedures. (Decree-Law nº 1.804, of September 3, 1980).

106.- Free Transit Licence for vehicles crossing international borders is no longer required. (Norm SRF 094, of September 9, 1980).

107. Brazilian products purchased in the internal marked are permitted to be taken out of the country as long as no commercial purpose is involved and certain rules are complied with. (Norm SRF 95, of September 9, 1980).

108. The substantial extension of terms of validity for medical and mental exams, required by the Conselho Nacional de Transito - CNT (National Traffic Council) for the renewal of driver's licenses, is approved. Except for a few cases, the first exam will be valid until the driver is 40 years old, renewable every 10 years from this period on up to 65 years old; thereafter it must be renewed every 5 years. (CNT Resolution 563/80, of September 19, 1980).

109. A new simplified model of the National Driver's License is approved, without the need of photograph and signature, in order to allow its issuance by computer. (CNT Resolution nº 565, September 19, 1980).

110. Appeal from judicial decisions rendered against the Federal Government, involving an amount equal to or less than 100 ORTN (Readjustable Treasury Bonds), is no longer compulsory (Law nº 6.825, of September 22, 1980).

111. Appeal from judicial decisions rendered in connection with expropriation lawsuits, brough by the Federal Government, Autonomous Agencies and State and mixed-capital companies, is no longer required when the amount of the indemnification does not exceed 30 times the sum offered in the complaint. (Law nº 6.825, of September 22, 1980).

112. Appeal from judicial decisions rendered against the Federal Government, in connection with labor cases involving an amount equal to or less than 100 ORTN (Readjustable Treasury Bonds), is no longer compulsory. (Law nº 6.825, of September 22, 1980).

113. The transfer of funds collected by the Federal Government and due to the States and Municipalities, pursuant to constitutional and legal prevision as to the percentages of distribution and allotment criteria, is simplified, decentralized and automatized. Previous approval of Application Plans for such funds by Federal units is abolished. (Decree-Law nº 1.805, of October 1, 1980).

114. Procedures for payments to employees, beneficiaries, retired personel and consignees of the Ministry

of Finance are simplified. Payments can be effected through bank deposits in individual or joint accounts, payment slips or nominative checks. (Ministry of Finance Directive nº 337, October 2, 1980).

115. Customs clearence of goods brought by passengers coming from abroad, up to the limit of US$ 800, is simplified. Import declaration is no longer required, allowing the entry of goods even when the issuance of import license in connection with said goods is suspended or prohibited. Up to US$ 800 there will be no seizure of goods, the only requirement being the payment of the corresponding taxes when the passenger arrives. (Norm 112, of October 30, 1980), issued by the Revenue Agency).

116. The mandatory execution of agreements related with the implementation of programs conducted by the Ministry of Interior is revoked. The allocation of funds will be effected upon simple approval by the Minister of the related Plans of Investment. (Ordinance GM 157, of October 30, 1980, of the Minister of Interior).

117. LBA - Fundação Brasileira de Assistência (Brazilian Social Assistance Foundation) is authorized to issue certificates allowing poor people to obtain exemption of fines applicable by the Civil Registry in case of late birth registration, as well as free legal assistance. (Law nº 6.848, November 12, 1980).

118. The Special Out-of-Court Settlement Program concerning debts to the Treasury is instituted within the Legal department of the Treasury. A twenty day time limit is fixed for out—of-court settlement of debts. (Directive nº 183, of November 18, 1980).

119. Payment to dependents or heirs of values which were not received by the deceased is authorized, without the need of probate proceedings, in the following hypotheses:

a) sums owed by employers and the Federal, State and Municipal Governments to their employees and civil servants;

b) individual deposits in the "Fundo de Garantia do Tempo de Serviço" (Guarantee Fund Lenght of Employment) and the "Fundo de Participação PIS-PASEP" (Employees Participation Funds);

c) income or other tax refunds owed to taxpayers;

d) bank balances or saving accounts and investment funds which do not exceed 500 ORTN (Readjustable Treasury Obligations).

(Law nº 6.858, of November 24, 1980).

120. The supply of information to the Revenue Agency concerning real estate transactions is simplified. (Norm SRF 129, of December 2, 1980, of the Revenue Agency).

121. The presentation of certificates of goods conduct or negative criminal record before Ministry of Labor and other professional registries is abolished and replaced by a statement signed by the interested party. (Law nº 6.868, of December 3, 1980).

122. Income Tax Laws and Regulations are consolidated (Decree nº 85.450, of December 4, 1980).

123. Limitations on the applications by States and Municipalities of funds collected by the Federal Government and legally due to such States and Municipalities are abolished. (Decree-Law nº 1.838, of December 23, 1980).

124. Requirements for enrollment and transfer of students at college and university levels are reduced. (Ministry of Education Directive nº 107, of January 28, 1981).

125. Evidence of homonymy may be hanceforth made through a simple declaration signed by the interested party; said declaration shall be accepted by all Units and Agencies of the Federal Government. (Decree nº 85.708, of February 10, 1981).

126. The granting of retirement, remuneration, review, reclassification, and special pensions, in the ambit of the Ministry of Health, is simplified; the Board of Review, Classification and Homologations, contemplated in article 10 of Ordinance MS 605, of October 17, 1979, is extinguished. (Ordinance 369 GM, of December 26, 1980).

127. SISAP - System of Public Attendance is instituted within the ambit of the Ministry of Finance, aiming at the simplification of internal proceedings of the Ministry's Units and the improvement of the quality of services rendered to the public. (Ordinance 001, of January 5, 1981).

128. Requirements for enrollment and transfer of higher level students are reduced, and Federal and State regulations regarding notarization of signatures are also applicable in this connection. When enrolling, the student should only produce his identification card, voter certificate (if over 18), evidence of compliance with military duties, and certificate of completion of second grade or equivalent graduation. In case of transfer (to another educational institution), identity card and the document of transfer from the original institution will suffice. (Ordinance 107 MEC, of January 18, 1981).

129. Small companies which select to pay income tax based on assumed profits are released from keeping accounting

records in connection with Social Security. (Circular IAPAS 07, of January 29, 1981).

130. The use of mechanical signature in the documentation related to customs clearence of goods is permitted. (Norm SRF 19, of March 24, 1981).

131. Administrative reorganization of the Ministry of Education and Culture is determined, aiming at better coordination and higher efficiency, as well as simplification of structures and reduction of operational costs, under the guidelines of the National Debureaucratization Program. (Decree nº 85.843, of March 25, 1981).

132. Authority is delegated to higher education institutions in order to permit them to fix the conditions required for the performance of monitoring functions. (Decree nº 85.562, of March 31, 1981).

133. Monetary correction shall apply on any debts resulting from court decisions, including costs and attorney's fees. (Law nº 6.899, of April 8, 1981).

134. Police authorities are prohibited to mention in criminal record certificates notations relating to inquiry procedures, except in case of previous conviction. (Legislative initiative). (Law nº 6.900, of April 14, 1981).

135. The granting of credit to small rural producers is simplified through elimination of presentation of a project when the amount involved does not exceed 2.000 MVR (Maximum Reference Value). Technical assistance to farming is reinforced. (Resolution 169, of April 22, 1981, of the National Monetary Council).

136. All agencies and Units of the Federal Administration are prohibited from instituting and distributing to individuals, corporations, taxpayers or users of public services, forms or questionnaires for compulsory disclosure or information which:

a) are available in other Agencies or Units;

b) are not strictly required for the performance of their essential functions; and

c) imply in excessive or unjustified cost for the person from whom the information is required. (Decree nº 86.009, of May 15, 1981).

137. Periodic disclosure is to be effected by the Modernization and Administrative Secretariat (SEMOR), of SEPLAN-PR, of updated lists of Agencies and Units which keep or manage data banks, records, registrations or other systematic information records to which the interested parties may apply. (Decree nº 86.009 of May 15, 1981).

138. Institution of compulsory completion forms and questionnaires is subject to previous demonstration of their essentiality and favorable approval of the Minister for Debureaucratization. (Decree nº 86.009, of May 15, 1981).

139. Organization Assistance Program for the decentralized units of the Revenue Agency is instituted, including:

a) general organization aspects;
b) managing performance;
c) operation of technical systems; and
d) standard of public information service.

(Ordinance SRF 301 of May 15, 1981).

140. Optional Attendance System (SAO) is instituted in Banco do Brasil, with the objective of offering to the client and option to use the Bank service without the need of going to cashiers or wait at public information counters. (May 26, 1981).

141. Withholding tax will not apply to salary income below Cr$ 1.000,00, beginning June 1, 1981. (Ordinance 125, of May 18, 1981), MF).

142. Withholding tax will not apply to income below Cr$ 500,00, beginning on June, 1981, in cases of remuneration for judicial services, cessating profits, and interest. (Ordinan 125, of May 18, 1981, MF).

143. Importation of maps, books, newspaper, magazines and similar publications and subscription of foreign newspapers and magazines is simplified. Previous approval of the Central Bank of Brazil is no longer required. (DECAM Communiqué 324 of June 9, 1981, of the Central Bank of Brazil).

144. Copyrights transfers are simplified in connection with:

a) books or records to be published or divulged in the country; and

b) sale in the country of material published in the Press, through execution of a term of responsibility, under the penalty of law, without the need of previous approval from the Central Bank of Brazil. (DECAM Communiqué 325 of June 9, 1981, of the Central Bank of Brazil).

145. Transfers relating to payment of press and news agencies abroad are simplified, through execution of a term of responsibility by the interested party, without the need of previous approval from the Central Bank of Brazil. (DECAM Communiqué 326 of June 9, 1981, of the Central Bank of Brazil).

146. Authority is delegated to the Minister of Education and Culture to authorize faculty personnel of official educational institutions to travel abroad for whatever purpose,

and regardless of the juridical nature of the institution and the expenditure regime to be observed. (Decree nº 86.128, of June 17, 1981).

147. Payment of publication abroad, in connection with advertisements and material intended to promote Brazilian export of goods or services abroad, is simplified, without the need of previous approval from the Central Bank of Brazil. (DECAM Communiqué 331 of June 25, 1981).

148. Payments abroad, whenever requested by busines entities established in the country, to agents of advertising companies abroad, in connection with material intended to promote directly or indiretly Brazilian exports of goods or services, is not subject to withholding tax; no previous approval from Centr. Bank of Brazil is required. (DECAM 332 of June 25, 1981).

149. Limit for remittances requested by book publishing companies intended to prepay imports of technical, scientific, didactic and literary books ordered by clients individuals or corporations residents or domiciled in the country, is increased to U$ 600.; no previous approval from Central Bank of Brazil is required. (DECAM Communiqué 334 of June 29, 1981).

150. Transfers abroad requested by exporting companies for payment of exchange expenses related with export operation, such as those referring to weight, type or quality storage, arbitration expert's report differences, inspection or

goods checking, cable, postage and judicial expenses, are simplified, no previous approval from the Central Bank of Brazil is required. (DECAM Communiqué 335, of June 29, 1981).

151. Transfers by way of return abroad of residual values not in excess of 5% (five percent), relating to previously paid exports, not applied in Export Licences or which have not been attached to the Export Return, are simplified. The transfers should be performed by the establishement with which the related exchange operation has been negotiated, through evidencing the effective and regular application of the value of prepayment to liquidate the exchange contract executed with the exporter, without the need of previous approval of the Central Bank of Brazil. (DECAM Communiqué of June 29, 1981).

152. Certificates of good standing with PIS is simplified, with substantial reduction of the documents required. (OC. SUPRO 013/81 of June 22, 1981, of Caixa Econômica Federal Federal Savings Bank).

153. General Financial Principles applicable to the Municipalities with up to 50.000 inhabitants are simplified. (Decree-Law nº 1.875, of July 15, 1981).

154. Occupation charges in an amount not in excess of 05 ORTN (Readjustable Treasury Bonds), related to real estate owned by the Federal Government, will no longer be collected. (Decree-Law nº 1.876, of July 15, 1981).

155. Inter-government real estate transactions or transactions intended to housing programs of social interest are exempt from transfer tax. (Decree-Law nº 1.876, of July 15, 1981).

156. Authority is delegated to the Minister for Debureaucratization for the purpose of issuing general norms and specific recommendations to be complied with by the Federal Administration, with the objective of assuring effective compliance with the acts issued within the scope of the National Debureaucratization Program. (Decree nº 86.210, of July 15, 1981).

157. The transfer of Federal Agencies and Units to Brasília is suspended. The objectives of the Decree are to prevent the aggravation of the Federal Capital infrastructure problems, and permit, through adequate administrative decentralization, that the problems of interest to users of public service are resolved without the need for their displacement to Brasília. (Decree nº 86.211, of July 15, 1981).

158. Creation of new Federal Autonomous Agencies, Federal state companies, mixed economy corporations and foundations is restricted. Whenever required, limited and specifi flexibility will be granted to existing Units of the Direct Federal Administration, under article 172, of Decree-Law 200/67. (Decree nº 86.212, of July 15, 1981).

159. Bonus for Handling and Social Security Qualification ("Gratificação de Atendimento e Habilitação Previdenciária"), to be granted to medium level servants specially trained to serve the public directly in units of the National Social Security and Welfare System - SINPAS, is instituted. (Decree-Law nº 1.877, of July 15, 1981).

160. The Program for Improvement of the INPS attendance services is instituted. (Decree nº 86.214, of July 15, 1981).

161. Transfer of state controlled companies to the private sector is determined, in accordance with article 3, letter "h", of Decree nº 83.740, of July 18, 1979. (Decree nº 86.215, of July 15, 1981).

162. Monetary correction (indexation) shall apply to any debt resulting from judicial decisions. (Law nº 6.899, of April 8, 1981).

163. All financial institutions, whether private or governmental, are required to adopt simplified homonymy evidence procedures, in accordance with Decree nº 85.708, of 1981 (Circular nº 627, of April 9, 1981).

164. A Special De-Statization Committee is established, pursuant to Article 6 of Decree nº 86.215, of 1981. (Interministerial Ordinance nº 100, of July 29, 1981).

165. Gross revenue limits adopted for taxation of rural activities by individual are increased, thereby resulting in substantial simplification of accounting and fiscalization procedures. (Norm SRF nº 65, of September 9, 1981)

166. The registration of firms and companies in the Commercial Registries ("Juntas Comerciais") is drastically simplified, including the elimination of documents, certificates and other requirements related with crossed controls. Registration shall be effected within a maximum of 3 (three) days. (Law nº 6.939, of September 9, 1981).

167. Participation in public examination for employment in the Federal Administration is simplified. In the act of registration of the candidate, the only document required will be the identification card and a signed statement to the effect that he has all the other documentation related with the examination. (Decree nº 86.364, of Semptember 14, 1981).

168. Implementation rules, with respect to de-statization and divestiture by the Federal Government of its companies, are established in conformity with Decree nº 86.215, of 1981 (Interministerial Ordinance nº 121, of Semptember 14, 1981).

169. Withholding tax will no longer apply with respect to certain payments or credits to individuals with residence in Brazil, when said payments or credits should have

been effected in previous fiscal years (Ordinance nº 066, of September 24, 1981, of the Revunue Agency).

170. The Tax Convention among States ("Convênio SINIEF") is amended, by recommendation of the Ministry for Debureaucratization, in order to permit each State to reduce or eliminate accessory obligations, such as book-keeping and other accounting requirements, in connection with the Tax on Circulation of Goods (ICM). (Amendment nº 02/81).

171. Participation in public tenders, for the rendering of services or the sale of goods and materials to the Federal Administration, is simplified. The limits applicable to each form of public tender, as well as to the dispensation therewith, are increased, aiming at the improvement of quality of services and reduction of costs to the Administration and individuals or business entities. (Law nº 6.946, of September 17, 1981).

172. The delegation of authority does not entail loss thereof by the delegating agent. (Decree nº 86.377, of September 17, 1981).

173. Payments to companies whose shares are traded in the Stockmarket or over-the-counter market shall not be subject to withholding tax. (Norm 067, of September 30, 1981).

174. Payments made by Agencies and Units of the Administration, as well as by private entities, related with the reimbursement or indemnification of travelling and similar expenses and bonus vacation, shall not be subject to withholding tax. (Norm SRF nº 069, of October 15, 1981).

175. The purchase and exchange of materials and goods is simplified in the Federal Administration, in accordance with Law nº 6.946, of 1981. (Norm 128, of November 3, 1981, from DASP).

176. The operation and performance of organs belonging to the Industrial Technology System is reorganized and improved. (Decree nº 86.550, of November 6, 1981).

177. The hiring of technicians and specialized personnel by Organs of the Federal Administration with relative autonomy is permitted, subject to applicable legal provisions. (Decree nº 86.549, of November 6, 1981).

178. Debts with Federal Autarchies, in an amount not exceeding Cr$ 3.000,00, constituted until November 13, 1981, are cancelled. (Decree-Law nº 1.889, of November 12, 1981).

179. The presentation of health certificates and similar documents, in connection with the enrollment in any cou provided by Federal educational institutions, is abolished.

Private and State and Municipal institutions are advised to take identical initiative. (Interministerial Ordinance nº 613, of November 16, 1981).

180. Authority is delegated to the Minister of Labor to appoint the Chairman of the Federal Biblioteconomy and Chemistry Councils. (Decree nº 86.593, of November 17, 1981).

181. One single format and size of photogragh shall be adopted by all Federal Agencies and Units. (Ordinance nº 011, of November 23, 1981).

182. Application of monetary correction to judicial debts is regulated by Decree nº 86.649, of November 25, 1981.

183. Rules applicable to deduction of expenses related with professional training programs, for purposes of determination of taxable corporate income, are simplified. (Decree nº 86.652, of November 26, 1981).

184. The registration of educational diplomas and corresponding certificates of conclusion of courses may be the State Secretariats of Education; registration with the Ministry of Education is no longer required. (Ordinance nº 629, of November 26, 1981).

185. Fines applicable to debts with the Federal Tresury, constituted until December 31, 1979, may be paid with a reduction or totally waived. (Decree-Law nº 1.893, of December 16, 1981, and Decree-Law nº 1.931, of March 19, 1982).

186. The rules applicable to taxation on income of firms and companies are adjusted in order to benefit a greater number of taxpayers. (Decree-Law nº 1.895, of December 16, 1981).

187. Simplified registration of companies with Commercial Registries is regulated by Decree nº 86.764, of December 22, 1981).

188. The norms pertaining to photographs on Labor Identification Cards are simplified. (Ordinance nº 12, of December 23, 1981).

189. Authority is delegated to the Ministry of Education and Culture to appoint members of Directors and Curators Councils and equivalent organs. (Decree nº 86.868, of January 21, 1982).

190. The creation of new printing and graphic units within the Federal Administration is prohibited, considering that the private sector is suffiently capable to render these services. (Decree nº 86.873, of January 26, 1982).

191. Memoranda, letters, communications, notices and all forms of correspondence shall be governed, within the Federal Administration, by simplicity, clarity, objectivity and conciseness. (Norm 133, of March 2, 1982, issued by DASP)

192. Registration in public examination tests ("vestibulares"), for admission to University courses, may be effected by a representative of the candidate, without the need of presentation of formal proxy. (Ordinance nº 87, of March 4, 1982, MEC).

193. A Working Group is organized in the Ministry of Agriculture, with the purpose of proposing and implementing measures aiming at the simplification of registration files and lists of products. (Ordinance nº 054, of March 4, 1982).

194. The transit of goods through customs is substantially simplified. (Norm SRF 008, of March 9, 1982).

195. The substitution of lost official documents is substantially simplified. (Ordinance nº 01, of March 9, 1982, Minister of Debureaucratization).

196. Authority is delegated to the Minister of Justice to suspend the operation of entities and associations referred to in Article 6, of Decree-Law nº 9.085, of March 25, 1946. (Decree nº 87.056, of March 23, 1982).

197. Utilization of mail is authorized in
ıection with the presentation and transmittal of applications
documents to Agencies and Units of the Federal Administration.
ıinance nº 012, of April 12, 1982).

BILLS PENDING BEFORE THE CONGRESS

1. Simplification of probate proceedings when the heirs are of legal age and in agreement as to the division of the estate.

2. Elimination of registration of diplomas in the Federal Education Council. If approved by the Congress, the law well benefit approximately 240 thousand graduates per year.

3. Elimination of the "plaqueta" (small plate intended to indicate that the vehicle has been inspected by traffic authorities) that goes on the top of each vehicle's plate. The "plaqueta" must be replaced, at present, in millions of vehicles, every year.

4. Simplification of voter's registration procedures (voting is mandatory to all Brazilian citizens) and of transfer of voting domicile.

DRAFT BILLS TO BE SENT TO THE CONGRESS DURING THE NEXT FEW MONTHS

1. Substantial simplification of the Code of Civil Procedure.

2. Simplification and revision of arbitration procedures.

3. Reduction of the hypotheses where notarization of signature is required, and simplification of norms applicable to authentication of copies of documents.

4. Elimination of various certificates and their substitution by written sworn statements of the interested parties.

5. Simplification of notarial acts (deeds and contracts that, by virtue of law, must be transcribed in notarial registries).

- SECTION 6 -

POPULAR MORTGAGE: A FIRST STEP TOWARD LEGAL SECURITY AND DEMOCRATIZING CREDIT

INSTITUTE FOR LIBERTY AND DEMOCRACY

POPULAR MORTGAGE: A FIRST STEP TOWARD LEGAL SECURITY AND DEMOCRATIZING CREDIT

Preliminary Version-Working Paper

Albert Forsyth
Director, Property Rights Project

Lima, June 1989

(Original Text in Spanish)

TABLE OF CONTENT

Page

INTRODUCTION..... 3

I. INFORMALITY, HOUSING AND ACCESS TO CREDIT..... 3

A. Economic Importance of Informal Housing..... 9

B. Informal Housing in Peru..... 14

C. Informality and Access to Credit..... 16

II. POPULAR MORTGAGE: A FIRST STEP TOWARD LEGAL SECURITY AND DEMOCRATIZING CREDIT..... 18

A. Component 1: The Land Register..... 20

B. Component 2: Popular Mortgage..... 38

C. Component 3: Credit Insurance..... 44

III. CONCLUSIONS: ADVANTAGES OF THE POPULAR MORTGAGE SYSTEM..... 47

ANNEXES..... 56

INTRODUCTION

The purpose of this report is to introduce and explain the workings of popular mortgage system created by the Institute for Liberty and Democracy (ILD), adopted by the Peruvian government under Legislative Decrees No. 495 and 496. Thus, the report is divided into three main sections, the first of which deals with potential relations between informal housing and access to credit, the second with the popular mortgage itself and the third, on a concluding note, with the system's advantages for Peruvian society in general.

However, as you will see for yourselves, the report not only introduces and explains the popular mortgage system but also clearly demonstrates the underlying principle of our research efforts, namely that informality is not an economic development model but merely a dramatic illustration of the chasm between Peruvian law and reality, requiring a new legal institutional framework which not only formalizes informal status but, at the same time, informalizes the formal sector, to promote equal access to business opportunities for all Peruvian citizens.

I. INFORMALITY, HOUSING AND ACCESS TO CREDIT

1. Based on its nine years of studies of the legal and economic reality of Peru, the Institute of Liberty and Democracy

was the first to establish the existence of a large segment of society engaged full or part-time in what are popularly known as "informal activities".

Informality is a concept developed by the ILD based on empirical observations of this phenomenon. It is not people who are informal, only status and their activities. Nor does informality correspond to any one specific static segment of society, but is rather a grey area paralleling the legal world where people take refuge when the cost of legality outweighs corresponding benefits. Only in rare instances does informality imply breaking all laws in general. In most cases only certain specific legal provisions are violated.

Informal activities also include those for which the government has created a special legal treatment under which a person may engage in informal activities, though not necessarily with the same legal status as those enjoying the full protection and benefits of the law. Thus, informal activities those which, though carried on in pursuit of legitimate objectives by means of lawful activities such as building a house, providing a service or operating a business, fail to meet requirements and discharge formalities established by corresponding government regulations and, thus, are considered "unlawful".

Efforts to measure these informal activities have revealed the amazing entrepreneurial energy of the poorest segments of Peruvian society which, for example, in aggregate terms, generated 39% of the gross domestic product for 1984 using 60% of the total number of man-hours worked during this period at the nationwide level. According to our estimates, by the year 2000, informal activities will account for 61.3% of GDP, despite average productivity equal to only one third of that of the formal sector.(1)

2. The roots of informality lie in the overwhelming, cumbersome regulations imposed by government on business activity, presenting an obstacle for anyone attempting to do business and particularly for the nation's poor, due to the country's inadequate legislative system under which ill-advised laws are enacted behind closed doors, ignoring the real interests of the people and, and thus, are totally divorced from reality.

The number of legal requirements imposed by government and the cost of meeting such requirements in terms of both time and money thwart private enterprise in two ways. First, is by discouraging investment in economically sound activites and, secondly, by causing a large percentage of new business activity

---

(1) Estimating the Magnitude of Informal Business Activity in the Peruvian Economy, ILD, December 1988.

to be carried out informally, in violation of the law, due to the impossibility of complying with requirements imposed by government regulations. The fact that, in order to evade government regulations, those engaged in informal activities find themselves forced to do things backwards or in a different way or to call them by names meaning exactly the opposite is an excellent illustration of the absurdity of business regulations. Take the case of street vendors ("ambulantes"), who are a far cry from itinerant, with fixed locations that have a value in many cases ranging from US$500 and US$750 per square meter, which is higher than the unit price of land in the city's most desirable residential and business districts, or "microbuses" carrying anywhere from 45 to 100 passengers, the same number of passengers as so-called "omnibuses" operated by the municipal urban transit company using Dodge, Scania-Gabriele and Mercedes Benz vehicles, which themselves are nothing if not microbuses", or of the so-called "pueblos jovenes" ("young towns", the local expression for new-sites developments) which are neither towns nor new, many of which date back as far back as 1950, with several-year-old wide boulevards linking them to the heart of the city, despite which most of their residents have no legal title either to the plots of land they are occupying or to the buildings erected on such land.

3. One of the largest sectors of informal activity is the housing sector, offering a unique illustration of the chasm between government regulations and the Peruvian reality. Studies conducted by the ILD have found that, due to the controlled rental market and to distortions in the capital market, low-income groups are precluded from renting or purchasing formal housing or, in other words, from buying a plot of land, developing it for urban use according to corresponding municipal ordinances and ultimately building a dwelling to eventually live in, subject to the obtention of a municipal building permit.

In light of this fact, the legal alternative for these people is to apply for a grant of government-owned land, which is the case of most of the land on the outskirts of the nation's cities. However, as graphically illustrated in Figure No. 1, such land grants mean going through 207 administrative formalities with 48 different government agencies requiring a minimum of 43 months to complete. (2) Add to this another 40 months to obtain necessary land development and building permits, for a total wait in period of nearly seven years to find a place to live. In some case, total time adds up to 10 years.

---

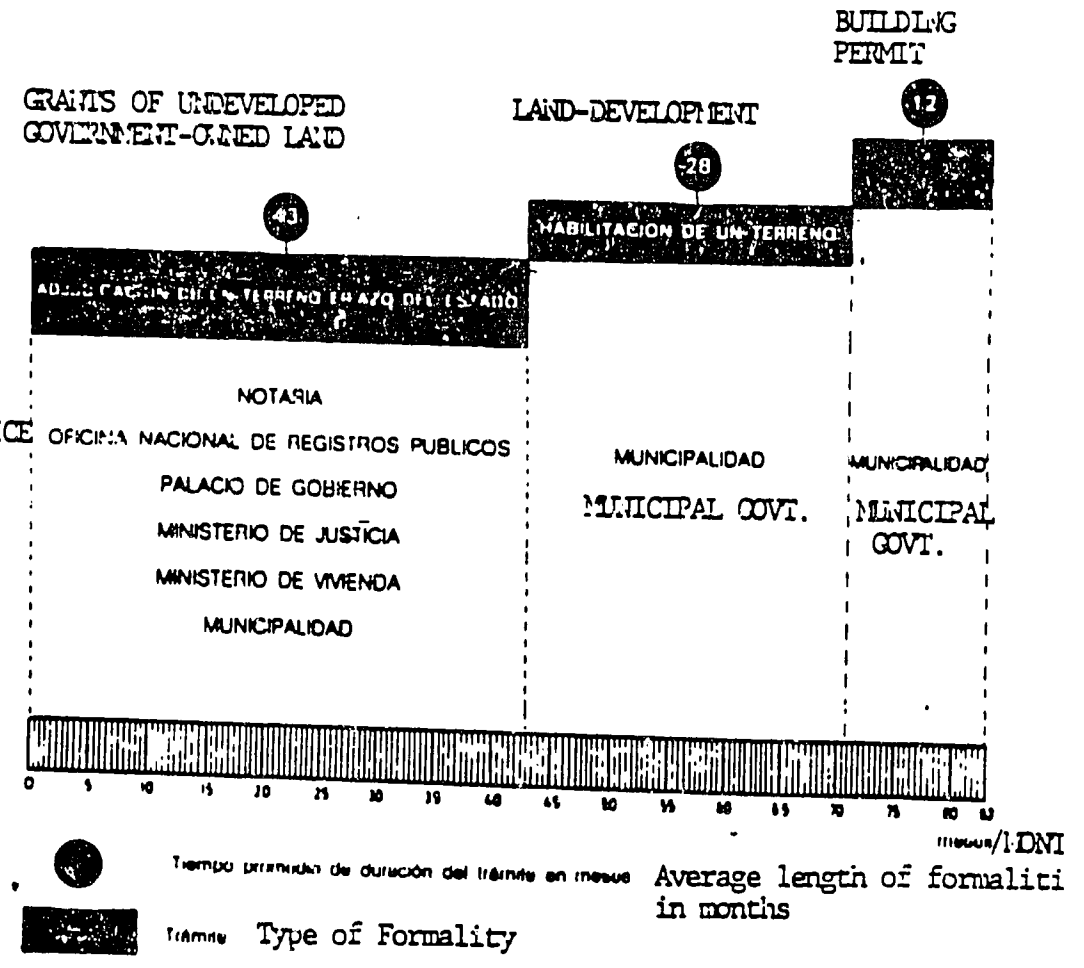
(2) The number of administrative formalities has recently been cut back to 116, involving 27 government agencies. However, the length of the land grant process has only been cut from 43 to 37 months.

GRAFICO Nº 1

Figure No 1

Trámites de acceso a la vivienda formal

FORMALITIES FOR ACCESS TO FORMAL HOUSING



NOTARY PUBLIC
NATIONAL PUBLIC RECORDS OFFICE
CITY HALL
MINISTRY OF JUSTICE
MINISTRY OF HOUSING
MUNICIPAL GOVT.

This is why, despite also being quite costly, the invasion and occupation of government and privately-owned land has come to represent the most effective alternative in providing shelter for the poor. The fact that, according to government statistics, there were 282 illegal occupations and only 3 official grants of government-owned land in Lima in 1985 and that seven out of each ten buildings constructed are informal dwellings is significant and clearly illustrates the inoperability of housing regulations.

A. ECONOMIC IMPORTANCE OF INFORMAL HOUSING

4. The ILD has continually maintained that poverty refers not only to the fact that the poor have no property of ther own and the low productivity of their resources but also to the hurdles they face in attempting to defend and derive maximum benefit from any property they do own. Not only do they find it difficult to purchase property, but they are also unable to register it in a simple and rapid manner, to use it as collateral in applying for loans, to sell it without the buyer having doubts in regard to its title, to rent it without fear that the tenant will take adverse possession, to prevent its use by third parties or to simply use it without any type of interference, resulting in the erosion of much of its value, despite the proven fact that free exercise of these inherent property rights i vital to economic growth.

One of the major differences between developing nations and industrialized countries lies in the operability of government regulations and procedures and the effectiveness of the legal system in safeguarding the exercise of property rights. Governments of developing nations place significant restrictions on the exercise of these rights by banning or curtailing them or by failing to offer protection from third-party interference, including government interference. In many cases this is caused by the country's preservation of ill-advised, harmful regulations and flawed, improperly regulated or anticipated legal systems.

5. A government which does not recognize the possessor or property as its rightful owner, considers the possession of such property illegal or refuses to recognize the transfer of such property to another party produces two negative effects jeopardizing the well being of its citizenry and the nation's overall economic development. In the first place, owners fear that, at any moment, the government or another party may strip them of their property rights without their being able to legally challenge the expropriation of confiscation of their property or, even if such legal remedies are available, that the system will not operate effectively. Under these circumstances, owners are hesitant to invest in expanding or improving their property or to expand the business in which it is being used. Thus, their

inability to freely exercise their rights undermines the value of their property, unnecessarily aggravating their poverty. The country also loses, in terms of its inability to take advantage of the benefical effects produced by the business which might have been carried on by the property owner. In the specific case of the legislation of squatter housing by granting occupants legal title to their dwellings, dealing with comparable socioeconomic groups, these benefits translate into an average level of investment in such housing nine times greater than its original value over a period of ten years. (3)

The second negative effect is a permanently stagnant market for such property. Nobody wants to buy property when its transfer is not recognized as legally valid. The result is that those who value the property the most or who can make the best use of it are dissuaded from buying it. Thus, the potential seller loses as a result of his inability to obtain a higher profit from the sale of his property than what he could earn by holding onto it. The buyer also loses by having to look for another less suitable business or property and, ultimately, the nation loses as well, in terms of lower levels of business activity and slower growth.

---

(3) See Annex No. 1.

Thus, for these reasons and in view of the importance of property rights, government must fulfill two related functions. First, it must recognize such rights at low cost and, secondly, it must protect such rights through legal institutions whose operating procedures do not present overwhelming obstacles to those who use them. When government fails to meet these objectives, large number of businesses are shut down and those which continue to operate become informal operators with no official status or protection and, hence, less profitable and becoming inefficient.

6. The housing sector is one of the best illustrations of informality in Peru, where oppressive laws have curtailed property rights to informal housing by 50%, hindering owners of such dwellings from selling, mortgaging, renting and investing in their properties, depriving them of protection under the law and creating a situation where owners are forced to rely on their own resources to protect their dwellings from government or other outside interference.

Moreover, those owners who have legalized their dwellings or who plan to complete necessary legalization formalities are finding it extremely costly to reap the benefits of government protection. The public registry is the mechanism through which home owners with legal title to their dwellings prove their legal

right to sell, mortgage, rent or improve their property. However, while this system works, it is too costly and ineffective, as discussed later in the report. Thus, those with legally recognized property rights are finding the cost of government protection of such rights increasingly high.

Once again, the property owner, the buyer, the potential tenant and the country all lose in such a situation. One type of loss is important enough to warrant special attention. Without legal protection or recognition, a dwelling may not be sold or rented, nor mortgaged for that matter, thereby precluding all possibility of converting the capital invested in such property into a generator of new resources. It is through such mortgage loans that significant number of small businesses are established in industrialized countries while, in Peru, this avenue of promoting small and medium-scale enterprises is nonexistent. (4) Nor can such dwellings be used as evidence of creditworthiness, thereby restricting access to all types of lines of credit from more credit cards to those with much higher credit limits.

---

(4) The importance of an efficiently operating capital market to development is widely recognized. See, for example, Lawrence J. Lau, Ed., Models of Development, San Francisco, 1988, ICS Press, Rondo Cameron, ed., Banking and Economic Development, (New York: Oxford University Press, 1972) and Ronald I. McKinnon, Money and Capital in Economic Development, Washington, D.C.: Banking Institution, 1973.

This not only hurts the nation's overall economic growth but, even more so, that of lower-income groups who generally have most of their savings invested in their homes. Thus, the goal of the ILD is to correct these government operation flaws and to avoid discrimination against such groups.

B. INFORMAL HOUSING IN PERU

7. Sector studies and research reveal there are currently 1,014 informal settlements (5) in Lima with 514,028 improved lots covering a third of the city, occupying approximately 14,500 hectares. This means that 50.6% of all existing housing in the Lima metropolitan area was built informally, in violation of government regulations, without satisfying current legal requirements, sheltering a staggering 53.6% of the city's population. (6)

---

(5) Informal settlements include all settlements know in Peru as barrios, slums, similar areas, low-income developments, resettlement areas, shelters, new-sites developments, marginal settlements, public housing projects, housing associations and cooperatives.

(6) The number of dwellings and residents in informal settlements was estimated as of March of 1988 on surveys of data from the records of individual settlements, which figures were subsequently projected to March of 1989 using official intercensal coefficients (1961/1981), revealing the fact that, as mentioned in the body of the report, 50.6% of the city's dwellings are located in informal settlements sheltering 53.6% of the total population.

Over the past forty years, informal settlers in Lima have built dwellings with replacement value plus land value equal to US$10,953 million, (7), or an average of $20,000 per unit, placing the nationwide aggregate replacement value of informal housing at US$20,272 million. This is approximately US$3 billion higher than the country's total foreign debt. Bear in mind that the number of informally-built dwellings is 47 times the number of housing units built by the government for this same population group over the same period and that government investments in low-income housing over the past quarter century (8) represent a mere 2.4% of investments by informal settlers.

8. However, only 24.9% of the occupants of informal housing in the city of Lima have title to the land and only 3.7% have title to the dwelling per se. (9) In other words, of a total of 514,028 housing units existing as of March of 1988, 127,992 occupants have duly recorded land titles, while only 19,019 have title to both the land and the dwelling. Thus, a total of 495,009 dwellings are legally inexistent.

---

(7) See Annex No. 2.

(8) De Soto, Hernando, El Otro Sendero (The Other Path).

(9) The March 1988 surveys referred to in Footnote (6) also produced the figure of 24.9% referring to the percentage of occupants of dwellings in informal settlements with title to the land.

The absence of legal title to land and housing means the occupant has absolutely no security and no legal status, precluding any possibility of using its inherent value as potential capital to generate additional income. Moreover, as indicated above, obtaining legal title to a dwelling, vesting it with legal status and security, can increase its market value significantly, which means not only getting a better price in the event of its sale, but also that the sale can be financed by a lending institution on better terms for the home owner.

C. INFORMALITY AND ACCESS TO CREDIT

9. Persons engaged in informal activities are considered "high-risk borrowers" by formal lending institutions for two basic reasons: first, because they are unable to prove their creditworthiness since such activities cannot be considered by formal institutions (subjective credit requirements) and, secondly, because they can offer no real security without title to their homes which, built in informal settlements, are nonexistent for all legal purposes and effects (objective credit requirements). Moreover, since nearly all such informal settlers are potential small borrowers, their evaluation as potential borrowers is extremely costly to banking establishments, resulting in their displacement by large borrowers.

Under these circumstances, informal settlers in need of credit are left with only two options: to resort to informal moneylenders to borrow relatively small sums of money repayable in two or three months at interest rates well above the official government rate or to apply for loans from other financial (mutual funds and cooperatives) and nonfinancial institutions serving the microenterprise sector such as IDESI, Accion Communitaria del Peru (ACP) and Care Peru, whose economic impact is negligable, as illustrated in the following paragraph.

10. Credit obtained by informal settlers through the above-mentioned channels is inadequate to promote their development. Thus, for example, the value of loans granted to these borrowers in 1986 by the aforementioned nonfinancial institutions represented a mere 0.2% of the value of lending channeled to the private sector through the formal financial system (10). While, as previously mentioned in Paragraph 1,

---

(10) The following comparison of informal and government activity is based on ILD calculations for 1986.

	SHARE OF GDP	MAN-HOURS USED	PERCENTAGE OF *EAP USED	SHARE OF FORMAL CREDIT
Informal Sector	34.6%	61.2%	48%	0.2%
Government	13.6%	6.9%	10.4%	37.2%

*Economic Active Population

informal activities generated 39% of GDP for 1984 using 60% of the total number of man-hours worked. (11)

II. POPULAR MORTGAGE: A FIRST STEP TOWARD LEGAL SECURITY AND DEMOCRATIZING CREDIT

11. Considering that credit is one of the most important factors in promoting business development, the ILD has created a system which overcomes present obstacles barring those engaged in informal activities from gaining access to credit.

In effect, after extensive studies and analyses of the legal and economic realities of Peru, the ILD has created a popular mortgages system as part of its efforts to gradually establish new legal institutions to help provide access to business opportunities for all Peruvian citizens. Under the ILD system, occupants of dwellings built in informal settlements can enjoy the inherent benefits of property ownership, including the right to use, possess (control), dispose of (sell, donate, mortgage) and recover (repossess from third parties) their property and, at the same time, use cumulative investments in the construction of

---

(11) See Annex No. 3.

their dwellings as security for the obtention of loans through the formal financial system.

12. The system has three basic components: the Land Register for Young Towns and Popular Housing Developments (land register), popular mortgage itself and credit insurance.

(a) The land register (also known as the possession register for reasons to be explained below) designed by the ILD allows informal settlers to rapidly and definitively register their dwellings for legal recognition of their rights. This registration formality enables the settlers to exercise corresponding property rights, permitting them to sell or use their property as security for a loan transaction.

(b) Popular mortgages, which are recorded in the land register, allow for the use of possessory rights and property rights to any dwellings erected on such land as loan security while, at the same time, creating a rapid, simplified foreclosure procedure, making them highly attractive as loan collateral.

(c) The credit insurance program uses insurance companies as financial intermediaries, which issue guarantees to banks on behalf of borrowers, assuring the banks of immediate loan recovery in the event of default by a given borrower.

These three companies are mutually complementary, forming a bridge between the banks and domestic savings, on one hand and informal income-producing activities on the other hand, supported by the land register, popular mortgages and credit insurance, as graphically depicted in Figure No. 2 below.

A. COMPONENT 1: THE LAND REGISTER

13. At present, the only existing government registry of real property rights is the real estate register which, as it name implies, is used exclusively to record titles to real estate and legal acts affecting real estate ownership, such as sales, leases, mortgages and legal attachments. Mere possession can not be recorded in the real estate register as it is expressly prohibited by law.

The real estate register is a centralized, cumbersome system employing obsolete registration procedures designed specifically for individual entries, not mass entries as required for the registration of informal settlements. As a result, after one hundred years in existence, its records show less than half of all formal housing in the Lima metropolitan area. Moreover, to make matters worse, nor are rights to even duly recorded properties totally secure since corresponding data is not

GRAFICO NO 2

Figure No 2

BANKS AND DOMESTIC SAVINGS

CREDIT INSURANCE

LAND REGISTER

POPULAR MORTGAGES

THE POOR AND INFORMAL ACTIVITIES

processed correctly, as illustrated below, doubling the time required to obtain a mortgage-backed loan.

Furthermore, the present register was designed according to the conventional home ownership process, namely the purchase and servicing of a plot of land, followed by the construction and occupancy of a dwelling, with corresponding entries in the real estate register made in the same order and record of the land title serving as basis for all subsequent entries.

However, this sequence of entries in the traditional register is inapplicable to informal housing, where the home ownership process is exactly the opposite in an attempt to evade government regulations, as explained above. In other words, the first step is to take possession of the land through informal occupancy or squatting. The next step is to build a dwelling and develop the land through the approval and registration of a survey and final site development plan. The last step is the acquisition of property ownership through the subsequent legalization of title to the land and to the dwelling erected on such land in accordance with regulations for the legalization of Youngtown. As you can see, the obtention of legal title is the last rather the the first step in this process. Thus, throughout the almost 10-year interval elapsing between the initial occupancy of the land and the obtention of legal title to the

corresponding dwelling, 30% of which are imperfect, the dwelling has no legal status whatsoever, resulting in the erosion in its potential capital value.

14. Considering the totally unrealistic nature of the traditional real estate register, in an effort to eliminate the incongruities of informal status, the ILD designed a new Land Register for young towns and Popular Housing Developments whose major innovation is its provision for the registration of property rights to dwellings built in informal settlements for the first time in the history of Peruvian legislation, once the government has recognized the existence and permanency of such settlement, granting corresponding title holders the same rights as those enjoyed by owners of formal dwellings. Thus, once the government has decided to grant possession, residents of informal settlements can obtain rapid, definitive legal recognition of their rights to their dwellings, which may then be disposed of or mortgaged to third parties, dispensing with the 207 administrative formalities with 40 government agencies requiring nearly seven years to complete. (12)

---

(12) See Footnote (2) on these 207 formalities.

15. The three main guidelines serving as basis for the design of the new register were simplification, deregulation and decentralization.

(a) Simplification refers to the greater transparency in the daily relations between the land register and those using its services. Thus, in this sense, simplification means creating institutional devices facilitating and reducing the cost of these relations, avoiding overlapping and eliminating impractical formalities and requirements to lower unnecessarily high charges to the public.

Thus, compared with the traditional registration system, the new land register has been simplified as follows.

Notarized certificates replaced by standard printed forms: To record rights to real estate, the present register requires notarized certificates or documents drawn up in the presence of a notary public and witnesses attesting to the existence of a formal contract and confirming the capacity and intent of the parties to such contract. These notarized certificates are long, formal, complicated statements drawn up based on other documents known as memorandums, consisting of the application addressed to the notary public containing the text of the contract and requiring signature by an attorney for presentation to the notary

public. The preparation and recording of notarized certificates can take anywhere from 30 to 60 days under the best of circumstances and cost approximately US$50.00.

The new land register replaces these notarized certificates by easily obtained standard printed forms that will contain the contract and establishes the property rights over the housing units. These will be completed with basic information on the parties concerned, the property in question and the transaction pertaining to such property, with only the signatures of the contracting parties requiring certification by a notary public or an attorney.

Building certificates replaced by standard forms and photographs: The traditional register of buildings constructed on real estate holdings requires presentation of a building certificate drawn up in the presence of a notary public based on a memorandum containing a detailed description of the type of structure, the building materials, the different rooms and room dimensions, signed by an attorney as well as by a civil engineer or architect. This memorandum describing the building must be accompanied by a municipal building permit, an inspection certificate attesting to the fact that the building was constructed as authorized by the building permit, a municipal numbering certificate and a receipt from the Peruvian Social

Security Institute as evidence that the builder has paid all corresponding social security contributions for workers employed on the construction site. A building certificate takes approximately four months to prepare at a cost somewhere in excess of US$100 depending on the particular building.

The sole requirement for the recording of buildings in the new land register is the submission of a standard printed form with basic information on the building in question, provided by an engineer or architect who will act as a private inspector accompanied by a photograph.

No proof of payment of property taxes required: To record a transaction in the traditional real estate register, the property owner must supply proof of payment of all outstanding taxes on the property in question through the presentation of corresponding receipts.

The new register requires no proof of tax payments whatsoever, first, because there's no reason for the recording of a title to real estate to be subject to the payment of property taxes and, secondly, because it is not the role of a real estate register to verify such payments.

In conclusion, unlike the present register in which everything the applicant says must be proven by documents, certificates and receipts from appropriate authorities, the new land register assumes the applicant is telling the truth (presumption of good faith), confirming the veracity of the information supplied through periodic sampling by private individuals selected specifically for such purpose.

(b) Deregulation is the transfer of decisionmaking power over certain matters currently in the hands of the real estate register to the individuals using such register. The new land register has been deregulated as follows:

Recognition of settlers' associations: Under the current system, associations of residents of informal settlements have no legally recognized powers in regard to real estate rights although, in practice, they do have certain de facto powers, though limited by their lack of legal standing.

The system established by the new land register creates an appropriate legal framework to delegate powers to settlers' associations or officials in young towns based on their own extralegal rules and regulations, empowering them to issue statements and certificates of occupancy recognizing such and

such a party as the title holder for a particular property to the exclusion of other parties.

Government bureaucrats replaced by private inspectors: Under the current registration system, inspections of property holdings in informal settlements are performed by government officials of the municipality in which the settlement is located.

Under the new system, inspections for purposes of verifying information supplied by occupants of informal dwellings are performed by private individuals appointed specifically for such purpose, such as engineers and architects, eliminating the need for administrative proceedings before municipal government agencies.

Separation of title registration and site development: According to the current registration system, in order to subdivide and grant title to individual plots of land in a popular housing development, the site development plan must be approved by the municipal government, executed and inspected by municipal government officials. Only after this is accomplished can its subdivision into individual plots be recorded in the real estate register for the granting of legal title to corresponding owners.

The new register specifically disassociates the titling of individual plots and dwellings from administrative formalities with municipal government authorities in regard to site development. The land register will record subdivisions and titles to urban plots of land without applicants being required to present corresponding site development plans.

User participation in register management: Under the traditional system, users play absolutely no role whatsoever in register management, supervision and organization.

User representatives are not only actively involved in the management and supervision of the new land register per se, but have direct oversight of corresponding administrative formalities and requirements to prevent their becoming overly cumbersome and complicated.

(c) Decentralization refers to the delegation of true decisionmaking powers to local registration offices, placing them in closer contact both with the local reality and with existing problems in need of solutions.

Until the creation of the new land register, the traditional real estate register has its decisionmaking powers concentrated at its Lima headquarters, with any registration formality liable

to be referred to its top decisionmaking authorities, making it unduly long, cumbersome and complicated. The new system decentralizes registration powers through the creation of autonomous regional registers (or departmental until the regional system is officially introduced), in turn further decentralized through the creation of district offices as needed. In this matter, the entire registration process is carried out from beginning to end within the area in which the property is located.

Applying the principles of simplification, deregulation and decentralization as described above, residents of informal settlements are given the opportunity of registering and obtaining legal title to their dwellings and reaping the benefits derived from their investments of capital and labor. Only through the simultaneous application of all three principles can we ensure that the new land register will operate smoothly and efficiently, streamlining administrative formalities, involving users in the system per se and delegating decisionmaking powers to the local office for the area in which corresponding property is located. Deviation from any of these principles will mean only partial modernization of the real estate registration system. We estimate that, within five years time, we will have registered 60% of all property holding in informal settlements, with 95% coverage in ten-years time. (13)

Even if such properties are not duly registered, the mere creation of the register enhances their value simply by offering the possibility of rapidly obtaining possessor rights to the land and title to the corresponding dwelling erected on such land.

16. The main features of the new registration system as compared with the traditional register are outlined below:

(a) Manual records replaced by a computerized system: Under the traditional system, all information is manually entered in two separate media, a system of books or "tomes" and a special card file typed by hand, requiring title searches to be performed manually with an unduly high margin of error in the accuracy of the resulting data. On the other hand, the new land register is fully computerized, with special property registration programs automatically comparing new data with prior information, accurately supplying the name of the title holder, a description of the property and a list of current liens and encumbrances.

(b) Only vital information is recorded: Under the current system, real estate transactions are recorded in the most minute detail, encumbering the register with the innumerable,

---

(13) See Annex No. 4.

complicated details supplied by corresponding notarized certificates.

In the new system, only that information which is strictly necessary is entered in the register, such as a general description of the property, the names of the contracting parties and the main terms and conditions of the corresponding transaction, with the data recorded on a special computerized registration form.

(c) Curtailment of the discretionary powers exercised by the registrar: Under the traditional system, registration requires the presentation of notarized certificates, as well as other documents such as receipts for tax payments, municipal building permits and inspection certificates. In practice, the registrar is in effect a judge, with such broad discretionary powers that six out of every ten titles presented for registration are rejected for some formal defect or another. (14)

By requiring only strictly necessary data for registration purposes, the new land register curtails the discretionary powers of the registrar who, in this case, is confined to simply transcribing the data supplied by specially designed forms.

---

(14) See Annex No. 5.

(d) Geographic location of property holdings: The traditional register places undue emphasis on the dimensions and individual identification of real estate holdings while, at the same time, failing to define their specific geographic location to pinpoint their position on a city map. Thus, the only way of locating a property in the traditional register is through the name of the corresponding property holder.

Giving less importance to their exact dimensions, the new register pinpoints properties by means of a number corresponding to a clearly demarcated space on the city map, such that records on any given property can be located either by the name of the property holder or by the address of the property per se.

17. The new land register not only modernizes the obsolete, complicated procedures of the traditional real estate register as described in the preceding paragraphs, but revolutionizes the entire registration system by taking into account the extralegal standards and regulations established by informal settlements, the present-day reality and the extralegal institutions operating in the informal housing sector. Thus, the new mortgage popular mortgage system embodies the following:

(a) Bricks as the original land title: The accuracy of recorded data on the boundaries and linear measurements of real estate holdings is verified by the registration of possessory rights to land and title to the structure erected on such land as a tangible fact, since the ILD has found that residents of informal settlements will erect a dwelling on their assigned plot of land only if they have at least some form of collective possessory security. In other words, they will build homes only if they are absolutely certain they will not be evicted. This legal security comes with municipal government approval of the corresponding survey, definitively allocating the land to the informal occupants and thereby recognizing its existence and location, in turn triggering home construction by informal settlers with permanent building materials in previously assigned plots of land, agreeing among themselves as to the boundaries of their respective plots based on the dwellings which are built side by side without leaving any space between them. In other words, the bricks used in the building process not only fix the limits of the dwelling unit per se, but also constitute the original title to such dwellings as the basis for their official registration.

Thus, in registering these dwellings we are also constituting accurate records of the boundaries and linear movements of the land held by each informal settler.

Moreover, while the new system is designed to record possessory rights to individual plots of land based on the dwellings erected on such land, it also allows for the registration of unimproved lots. However, this case requires prior approval by the municipal government not only of the survey of the informal settlement, but of its layout and site development plan as well, since only at this point are unimproved lots given definite, clearly defined dimensions.

(b) The occupant of a plot of land is the presumed owner of the building constructed thereon: As established in the preceding paragraphs and in view of the ILD finding to the effect that informal settlers will build with permanent building materials only on their duly assigned plots of land and only after the survey is approved by the municipal authorities, the new registration system provides that anyone in possession of a plot of land, even without formal title to such land, is the presumed owner of the buildings constructed thereon, applying to realty the same presumption contained in the current Civil Code in regard to personal property under which any one in possession of personal property is presumed to be the owner of such property by the mere fact of its possession, unless proven otherwise. Thus, extending this to realty in informal settlements, unless proven otherwise, the occupant of the land is also presumed to be

the owner of the building erected on such land. This has bridged the gap between the law and the reality existing in the urban areas of the country in which more than 50% of houses have been built on a plot of land where its occupancy have a possessory right and not a property right.

(c) Easing requirements for evidence of title and property boundaries: Present requirements and prescribed documentary evidence of titles to be recorded in the land register and correponding information on the physical location and boundaries of property holdings have been totally overhauled to take into account the daily lifestyle of residents in informal settlements.

The types of evidence required to verify land tenure rights have been based on the customs and extralegal standards and regulations studied by the ILD and are, therefore, both realistic and easily obtainable by users of the new land register. Examples include certificates of occupancy from the municipal government or other competent- authority and, where such certificates are unobtainable, other equally effective documents such as written statements from neighbors or local residents' associations verifying tenure, receipts for payments for basic services such as water, electricity, street paving, local residency and loan agreements with building and loan associations.

New forms of evidence of property boundaries have been developed to facilitate the registration of parcels of land in informal settlements and of the buildings erected on such land. The new registration system places greater emphasis on the description and location of the dwelling unit than on the exact dimensions of the land holding since, as indicated above, it is the structure erected on the land which defines its title.

Thus, a single act confers legal status on both the land and the building, which, in most cases, represents as much as 80% of the total property value. With the new system, recognition of corresponding dwellings has been replaced by a standard form supplying basic data on the building in question, accompanied by photographs of the property holding visually depicting the dwelling and boundaries with adjacent properties.

18. By creating a simplified land development procedure, the new land register also allows for the legalization of popular housing developments know in Peru as housing development associations, housing associations and housing cooperatives which, despite owning the land and having invested large sums of money in housing construction, cannot handle the enormous outlays of both time and money required for the completion of necessary land development formalities and the subsequent subdivision and

registration of individiual plots of land. Bear in mind that, according to the ILD definition of informality, these popular house developments, with their special legal status and treatment, are considered informal in the same manner as illegal or squatter settlements.

In order for these settlements to subdivide and officially register the individual plots of land comprising the housing development, the current system requires prior municipal approval of a professionally-prepared site development and subdivisional plan, plan implementation and subsequent inspection and approval of corresponding work by the municipal authorities. The new registration system requires only that the site development plan be submitted to the municipal government, whereby it is automatically considered approved after thirty days provided no objections are raised in the interim. Once the plan is approved, the site may be subdivided into individual plots for registration and allocation to cooperative or association members who, in turn, may use their properties as collateral for loan transactions.

B. COMPONENT 2: POPULAR MORTGAGE

19. The second element in the system known as the "popular mortgage", through which common people are able to use the value

of occupied land and that of the dwellings erected on such land as security for the obtention of formal credit.

Prior to the ILD proposal resulting in the enactment of Legislative Decree No. 469, under the rules of Peruvian civil law, only a real property owners could mortgage such property to a third party. Thus, a mere occupant could not mortgage land in his possession, despite the establishment of the new property registration system under which his possessory rights to such land and, if applicable, his title to the building erected on such land were duly recorded in the land register. Moreover, despite land possessions regulations for young towns requiring municipal authorities to grant legal title to informal dwellings, in practice, free exercise of the rights inherent in property ownership was sharply curtailed in that title holders could neither sell, rent nor mortgage their homes.

With this in mind, in an effort to derive economic benefit from large cumulative capital investments in informal housing, the ILD proposed creating a new type of mortgage for realty in informal settlements based on mere tenure rights which, duly recorded in the Land Register and Popular Housing Developments, grant corresponding title holders the inherent rights of property ownership, including the rights of use, enjoyment, disposal and recovery, creating a title free from any and all restrictions

and, for the first time in Peruvian history, making it possible to place a mortgage on a piece of real estate without formal title to such property.

20. The basic features of this new-style "popular" mortgage are as follows:

(a) The mortgage is based on possessory rights: Unlike the conventional mortgage referred to in the Civil Code requiring that the grantor have title to the property in question in order to establish a mortgage right thereon, popular mortgages are established on realty located in informal settlements based on mere possessory rights recorded in the land register. Note that, as previously indicated in discussing the land register, by presuming the occupant of a plot of land to be the owner of the building erected on such land, legally, the mortgage is placed on the tenure right to possess the land and the title to the dwelling, if there is a dwelling, both of which rights are linked for purposes of the mortgage, which considers the property an indivisible whole.

Bear in mind that, while the right of the landholder is referred to as a "possessory" right, he enjoys all inherent property rights, namely the right of use, enjoyment, disposal and

recovery, in effect making him the owner and not simply the possessor.

Moreover, presuming the holder of a plot of land to be the owner of the building erected on such land extends to realty the presumption established by the Civil Code to the effect that, unless proven otherwise, any one in possession of personal property is the owner of such property.

However, unlike the presumption of personal property ownership which may be challenged by the true property owner, proving the possessor does not in fact have such right, the presumption of ownership of informal dwellings may not be contested by previous land owners, whether private citizens or the government per se, inasmuch as, once such rights are duly recorded in the land register they become final. Thus, as soon as the title is duly recorded in the land register, the property may be mortgaged under the terms of a popular mortgage as security for formal credit.

Lastly, the new land register allows informal dwellings to be recorded upon approval of the site survey, before municipal government formalities for the conferral of title have been completed, in effect recognizing the title holder of record as the property owner. Thus, municipal government titling

formalities run parallel to this process until their conclusion, without affecting or modifiying the finality of the right previously conferred by the registration system.

(b) The mortgage is constituted on the basis of a standard registration form: The process of establishing a mortgage has been simplified dramatically by eliminating the need for a mortgage deed drawn up in the presence of a notary public. Popular mortgages are created on the basis of a standard registration form completed by the borrower and the lender and duly recorded in the land register, officially constituting the debt secured by the mortgage and the value of the mortgage placed on the property.

(c) Simplified judicial foreclosures: A new abbreviated judicial foreclosure procedure has been created to make popular mortgages an effective, rapidly enforceable security device. Prior to the enactment of Legislative Decree No. 495, foreclosures were subject to a long, tedious collection process, attaching the auctioning off the mortgaged property. This slow-moving judicial procedure, taking anywhere from three to four years, discouraged the granting of mortgage-backed loans, in which delinquent borrowers reaped the benefits of inflation and negative interest rates payable on such loans. The new procedure provides for immediate foreclosure in the event of default and

can be halted only through the presentation on documentary evidence of payment of the debt. Moreover, this type of foreclosure has been limited to an original and single appellate jurisdiction, eliminating the need for intervention by the Supreme Court, which only delayed the conclusion of these proceedings. Furthermore, in an effort to speed up the foreclosure process and protect corresponding lenders from harmful inflationary effects, discouraging them from continuing to go on lending, loan maturities have been shortened and public auctions of mortgaged property have been simplified to prevent borrowers from obstructing the process.

(d) Extrajudicial foreclosures: The final and most important innovation as regards foreclosures which makes some popular mortgage attractive to creditors is the design of a new extrajudicial foreclosure system. Obviously, even with the most streamlined judicial foreclosure proceeding, the slow-moving cumbersome nature of the Peruvian system of due process makes this legal remedy a highly unattractive prospect. Hence, the new extrajudicial foreclosure system establishes that, in constituting a mortgage on realty, the parties mutually agree to designate a third party such as a bank, notary public, magistrate or any other individual or corporate entity to sell the mortgaged property in the event the borrower should default on the

principal obligation to enable the creditor to recover the outstanding loan amount from the proceeds from its sale.

The third party charged with selling the mortgaged property in the event of default is appointed by means of a power of attorney drawn up in the form of a private instrument with signatures certified by a notary public, to be recorded in the land register together with the corresponding mortgage. In the event of nonpayment of the duly incurred debt, the creditor notifies the third-party agent who, in turn, promptly proceeds to sell the property within a maximum of thirty days.

C. COMPONENT 3: CREDIT INSURANCE

21. Nowadays, in granting loans, financial institutions require no only objective security devices such as mortgages, collateral or bonds, but the satisfaction of other subjective requirements such as verifiable formal sources of income.

It is virtually impossible for most Peruvians to satisfy these requirements, not for lack of income, but because such income does not come from formal sources and, hence, is nonexistent for all legal purposes and effects. This is particularly serious considering that 61.72% of the country's total population engages in informal activities, preventing

informal business owners from qualifying as "good credit risks" despite the wealth generated by their income-producing activities.

22. To bridge the gap created by these subjective requirements for access to formal credit, the ILD has recommended the use of insurance companies in a new mechanism whereby such companies play an active role in expanding access to credit based on a new type of insurance known as credit insurance.

Under the new credit insurance mechanism, insurance companies evaluate credit applicants from the standpoint of both income (regardless of its source) and objective security devices and assume the risk of default by borrowers vis-a-vis corresponding lending institutions. These services are rendered in return for the payment of a premium equal to 4% of the full amount of the loan and the creation of a mortgage in favor of the insurance company, in an arrangement which is extremely advantageous for informal borrowers accustomed to paying three to six times the interest rate charged by the formal financial system. Thus, the responsibility for evaluating loan applicants is transferred from the lender to the insurance company, streamlining the lending process and enhancing its appeal since repayment is fully guaranteed. The credit risk is assumed by the insurance company through the insurance coverage offered by the

company in return for the collection of premiums from large numbers of policy holders.

ANNEX 1

Based on a sampling of human settlements with differing legal status, we have shown that the average value of houses with property title is 9 times higher than the value of houses without a title.

This figure was obtained from a sample survey of human settlements with varying degrees of legal recognition. The sample included 38 settlements, each represented by 20 individual plots. Our first step was to compare the average value of dwellings in settlements at both ends of the scale, namely those whose occupants had legal title to their dwellings versus squatter settlements, obtaining the following average building values per square meter for both types of legal status:

Average Value, per square meter
(in 1984 soles)

Squatter	Titled
68.05	333.17
(6 observ.)	(12 observ.)

This gave us a ratio of 4.9 to 1 between the average value of a legally secure dwelling compared with a dwelling with no legal security whatsoever.

We then eliminated from the sample certain observations likely to produce an upward or downward bias in average values, giving us the following figures:

Average Value, per square meter
(in 1984 soles)

Squatter	Titled
33.53	313.05
(3 observ.)	(7 observ.)

This, in turn, gave us a ratio of 9.3 to 1 (or 9.1) between the building value of legally secure dwellings and that of dwelling units with absolutely no legal protection. We simultaneously followed an alternate approach using econometric methods to isolate the effects of income and age variables, producing extremely similar results.

ANNEX 2

The value of dwellings in informal settlements was based on the number of such dwellings as estimated by the ILD in March of 1988 at 498,089 units based on interviews with top community leaders. This figure was then projected to March of 1989 using the intercensal housing growth rate for the period from 1961 to 1981, giving us a total of 514,028 dwellings in informal settlements. We also assumed the same distribution of dwellings by stage of construction produced by field surveys conducted in 1986.

The next step was to calculate average building prices per square meter by type of dwelling unit using the 1986 official schedule of building values for coastal areas published by the Ministry of Housing, computing average unit building costs per square meter for each type of dwelling at list prices, for new-sites developments, housing associations, cooperatives and low-income housing developments.

To ensure that the resulting figure reflected real building costs, we calculated the ratio between resale prices for advertised home sales and the list price published by the Housing Ministry for the same type of dwelling, obtaining a relationship of 2.08 between replacement values and list prices.

We then multiplied the list prices per square meter for each type of dwelling by 2.08, giving us the building value at replacement prices.

We calculated land replacement values by adjusting the list price per square meter established by the Appraisal Department of 1986 for each land category by a factor representing the ratio between market and list prices, in turn calculated based on advertisements of land for sale in low-income settlements appearing in the daily paper El Comercio.

After calculating the land replacement value for 1986, we determined the share of land in total building value to be 5% in the case of new-sites developments and 15% for housing associations, cooperatives and low-income housing developments, using these two percentages to calculate the replacement value for 1989, arriving at an aggregate figure of US$10,953 million.

ANNEX 3

The value of loans from these nonfinancial institutions (IDESI, Accion Communitaria del Peru, Care Peru) was US$9 million at the official exchange rate. However, seeking a somewhat less distorted dollar value, we decided to use a parity rate developed by Apoyo, S.A., bringing the value of lending by the aforesaid institutions down to US$6 million.

National financial system data is based on government statistics Central Reserve Bank (BCR). At the parity rate, national financial system lending to the private sector would be US$2,736 million, in which case loans by nonfinancial institutions would represent 0.2% of the total value of lending by the national financial system.

Lending by the Banking System in 1986
(in millions)

	Total (Intis)	(US$)	Percent %
- Private Sector	48,409	2,290	62.8
- Public Sector	28,668	1,356	37.2
TOTAL	77,077	3,646	100.0

Lending by the Financial System in 1986
(in millions)

	Total (Intis)	(US$)	Percent %
- Private Sector	57,842	2,736	63.1
- Public Sector	33,790	1,598	36.9
TOTAL	91,632	4,334	100.0

Source: BCR, Annual Report for 1987.

Loans to Microenterprises from Private Nonfinancial Institutions

- Accion Communitaria del Peru	(at 8/30/86)	US$3,510,174
- FOGASI	(at 2/28/87)	528,936
- CARE	(at 2/28/87)	646,412
- IDESI	(at 12/31/86)	1,372,942
- FOFISI	(at 12/16/86)	10,420
		US$6,068,884

ANNEX 4

Our first step was to define the statistical population of the land register as consisting of 498,089 realty holdings in new-sites and low-income developments throughout the Lima metropolitan area as of March of 1988 (Period 0.) We then subtracted 29,486 dwellings for which we figured no surveys were available and, thus, would be difficult to record in the register. The next step was a projection of potentially recordable properties for the first five years of operation of the land register based on the intercensal growth rate of housing in the Lima metropolitan area for the period from 1972 to 1981.

The number of registrations in the first year of operation of the land register was estimated at 12,000 for each of the three district offices in Lima, for a total of 36,000 property registrations. Growth rates for property registrations in the following four years were estimated at 50%, 30%, 15% and 10% respectively, for a cumulative total of approximately 313,590 registrations by year five.

These growth rates for property registrations were calculated based on the operating experience of the National Public Records Office and the Mining Registry Office and on the computerized organizational structure and infrastructure of the popular mortgage project. The reason for the steady slowdown in

property registrations is that occupants of existing housing units in informal settlements are expected to press for their official registration in the early stages of operation of the land register.

ANNEX 5

The following summary of title registration statistics for land register headquarters of the province of Lima is based on the 1987 Statistical Yearbook published by the National Public Records Office:

Titles Presented for Registration	90,923
Titles Resubmitted	60,945
Titles Examined	39,330
Titles Contested	26,327
Titles Cleared	21,518
Titles Recorded	58,962

One indication of the obstacles confronted by persons applying for legal title to their dwellings is the ratio between the number of titles presented for registration and the number of titles resubmitted, according to which roughly six out of every ten titles presented have to be resubmitted to the Public Records Officew.

However, this indicator should be viewed with a grain of caution since any given title may be resubmitted more than once as a result of multiple examinations or challenges in the course of processing.

- SECTION 7 -

BUILDING CONSTITUENCIES FOR ECONOMIC CHANGE

BUILDING CONSTITUENCIES FOR ECONOMIC CHANGE:

Report on the
International Conference
on
The Informal Sector

Sponsored by
The Center for International Private Enterprise
and
The United States Agency for International Development

Held at the U.S. Chamber of Commerce, Washington, D.C.

October 26-27, 1987

Edited by John D. Sullivan, CIPE

Board of Directors

Chairman, Edward Donley
Chairman, Executive Committee
Air Products and Chemicals, Inc.

Stanton Anderson
Partner
Anderson, Hibey, Nauheim and Blair

William T. Archey
Vice President
Center for International Private Enterprise

Clyde Cole
President
Metropolitan Tulsa Chamber of Commerce

Peter Duignan
Director
Africa and the Middle East
Hoover Institution

George M. Ferris, Jr.
Chief Executive Officer
Ferris and Company

Dr. Constance B. Hilliard
Dallas Morning News

Robert H. Krieble
Public Affairs

Dr. Richard L. Lesher
President
U.S. Chamber of Commerce

Norma Pace
ECAP

Thibault de Saint Phalle
Saint Phalle International

Frank E. Smith
President
Greater Detroit Chamber of Commerce

Phil N. Truluck
Executive Vice President
The Heritage Foundation

Jay Van Andel
Chairman of the Board
Amway Corporation

October 20, 1987

Mr. William T. Archey
Vice President
Center for International Private Enterprise
Washington, DC 20062

Dear Mr. Archey:

I have received with interest the information which you sent me regarding the conference on the Informal Sector, sponsored by the Center for International Private Enterprise, an affiliate of the U.S. Chamber of Commerce, and the U.S. Agency for International Development, on 26 and 27 October, 1987. This is a subject of considerable importance in the today's world. Indeed, it is one to which increasing attention is being devoted at various levels in the United Nations system. The General Assembly, at its last session, approved a resolution regarding the role of indigenous entrepreneurs in economic development which is germane to the issue and which is to be followed up on in the future.

I take note, in particular, of the fact that my countryman, Mr. Hernando de Soto will be playing a prominent role in this Conference. As it happens, he is a member of the Committee for Development Planning, a high-level United Nations advisory panel. I am, of course, personally familiar with the work of Mr. de Soto, which I have long admired. His recent work, "El Otro Sendero," is a brilliant and exhaustive study of the economic and social problems of developing countries.

I wish you every success in your deliberations.

Yours sincerely,

Javier Perez de Cuellar
The Secretary-General
United Nations

Table of Contents

PREFACE

William T. Archey, Center for International Private Enterprise

OPENING ADDRESSES

Dr. Richard L. Lesher, U.S. Chamber of Commerce 2
Dr. Richard E. Bissell, U.S. Agency for International Development 4

THE INFORMAL SECTOR: ITS REAL AND POTENTIAL ECONOMIC CLOUT

Douglass North, Washington University, Moderator 6
Hernando de Soto, Institute for Liberty and Democracy, Peru 6
Marcos Victorica, Institute for Contemporary Studies, Argentina 8
Robert Litan, The Brookings Institution, Discussant 10
Discussion 11

GENERATING ECONOMIC GROWTH THROUGH MICROENTERPRISE AND INFORMAL SECTOR ASSISTANCE PROGRAMS

George M. Ferris, Jr., Ferris and Company, Moderator 14
Arthur Levi, International Finance Corporation 14
Nancy Berry, World Bank 15
Kenneth Cole, Inter-American Development Bank 16
Edward Marasciulo, Pan American Development Foundation 17
William Baez-Sacasa, formerly of the Nicaraguan Development Foundation, Discussant 18
Discussion 19

BUILDING GRASSROOTS CONSTITUENCIES FOR ECONOMIC CHANGE: APPROACHES

Jose Luis Yulo, Philippine Chamber of Commerce and Industry, Moderator 22
Hernando de Soto, Institute for Liberty and Democracy, Peru 22
Martin Burt, Paraguayan Foundation for Cooperation and Development 24
Adolfo Ruiz, Institute for Contemporary Studies, Argentina 25
Dr. Joao Geraldo Piquet Carneiro, formerly of the Brazilian Ministry of Debureaucratization 27
Luis Eduardo Magalhaes, Chambers of Commerce of Sao Paulo, Brazil 28
Dr. Edward Hudgins, Heritage Foundation, Discussant 30

BUILDING GRASSROOTS CONSTITUENCIES FOR ECONOMIC CHANGE: REPLICATION

Juan Bendfeldt, Center for Economic and Social Studies, Guatemala 33
Moncef Bouchrara, Ideas and Communications, Tunisia 33
Dr. I. Onyango, Ministry of National Planning and and Development, Kenya 34
Japie Moropa, Get Ahead Foundation, South Africa 36
Jesus Eduardo Rodriguez, Institute for Liberty and Democracy, Venezuela 37
Helen Soos, U.S. Agency for International Development, ... 38
Discussion 39

EPILOGUE 41

Preface

In October 1987, the Center for International Private Enterprise (CIPE), an affiliate of the U.S. Chamber of Commerce, and the U.S. Agency for International Development (A.I.D.) sponsored an international conference in Washington that brought together 250 business, political and academic leaders from 35 countries to examine a fresh approach to issues of economic growth and development.

The theme of the conference was the political and economic clout that the entrepreneurs of the informal sector can wield in the developing world today. Throughout the Third World, this informal sector comprises a vast underground market operating independently of governmental authority. It is usually treated as a problem of unemployed labor. Governments have attempted at various times to solve this problem through job creation schemes, formation of public enterprises, increased regulation of business, import substitution or benign neglect.

CIPE's purpose in publishing the conference proceedings is to reach a widespread international audience while providing the conference delegates with a written record of the discussions. It is our hope that decision-makers in the private and public sectors will find the presentations provocative and will seek to implement the programs and policy recommendations described herein, as may be appropriate to their countries. To this end, a summary menu of policy recommendations is provided in the epilogue.

"Building Constituencies for Economic Change" is part of CIPE's overall support for market-oriented approaches to economic growth and development. As such, the informal sector conference is but one in a series of CIPE sponsored initiatives to encourage the widespread adoption of programs and policies benefiting the entrepreneurs of the informal sector, the overall business community and society at large. Several follow-up activities are in the planning stage. For instance, CIPE plans to issue periodic reports, in newsletter format, as a forum for the exchange of new ideas and program approaches. Part of the process of producing the newsletter will involve surveying those attending the informal sector conference and others participating in similar programs. In addition to publishing information, CIPE will continue to provide financial support for private sector initiatives throughout the developing world.

Today, a revolution is occurring in development thinking—a revolution that comes from within the developing world itself. By looking at old problems in new ways, a group of Third World scholars and business people are now looking to the informal sector as a source of economic growth, rather than as a drag on modernization.

Studies in various countries demonstrate that between 30 percent and 60 percent of the work force and Gross Domestic Product (GDP) are in the informal or underground market. These informals are not part of the criminal class involved in drugs or other illicit activities. Rather, the informals are entrepreneurs who produce legitimate products without proper permits and legal status because they cannot cope with the red tape and other constraints preventing entry into the legal economy. As a result, they have formed a market system separate from the legal economy. Economic progress, however, requires both economic and political reform to remove the root causes of these dual economies.

In a capsule, the thesis put forth during the conference is this: the developing world is now at the threshold of the entrepreneurial revolution experienced in the developed world three centuries ago.

The idea for a conference on the informal sector approach grew out of the programs supported by the Center for International Private Enterprise in Latin America and Africa. However, it is the groundbreaking work of Hernando de Soto's Institute for Liberty and Democracy in Peru that forms the basis for the conceptual breakthroughs reported in the body of the report. De Soto's book, El otro sendero: la revolucion informal (The Other Shining Path: The Informal Revolution), first appeared in November 1986. Since that time, over 100,000 copies have been sold throughout Latin America. This is truly extraordinary for a public policy work.

This report summarizes the discussions from the day-and-a-half conference. Speakers reported on ongoing programs of research and policy advocacy being pursued in countries as diverse as Peru, Argentina, Venezuela, Paraguay, Brazil, South Africa, Tunisia and Kenya. While these programs are in different stages of development, Latin America being the most advanced and Africa just beginning, they share a common foundation. They all believe that the day of government centered development has passed—due to its obvious failure--and that market-oriented approaches are far more likely to achieve the goals of economic growth and human welfare.

CIPE and A.I.D. have a joint interest in the informal sector approach and its extension within Latin America and to other regions of the developing world. Both have supported the Institute for Liberty and Democracy over the last four years and both seek to encourage other peoples and countries to consider the market-oriented path to development.

The U.S. Chamber established CIPE in 1983 as an operating foundation to support market-oriented approaches to economic growth and democratic development in the the Third World. Over the last four years, CIPE has supported 66 programs in 28 developing countries, as well as a variety of international programs such as the Informal Sector Conference and the Journal of Economic Growth. The Journal is published by the National Chamber Foundation in English, Spanish and French, with a distribution base of 8,000 opinion leaders worldwide.

CIPE receives its funding from the National Endowment for Democracy through annual Congressional appropriations.

I would like to express my thanks to all of those who attended the Informal Sector Conference, many of whom traveled thousands of miles to participate. Their willingness to do so is testimony to the growing appeal of market economics and private enterprise as the most effective path to economic growth and human progress.

William T. Archey
Vice President

June 1988

PART I

OPENING ADDRESSES

Dr. Richard L. Lesher
President
U.S. Chamber of Commerce

On behalf of the officers and directors of the Center for International Private Enterprise and on behalf of the 180,000 companies that make up the United States Chamber of Commerce along with some 2,800 state and local chambers and 1,300 trade and professional associations, it is a great pleasure to welcome you to this International Conference on the Informal Sector. We are very pleased that the U.S. Agency for International Development is a cosponsor of this conference.

We've always believed that it's vital for the private sector and government to work together in all countries around the world in pursuit of sound economic policy. It is essential that business and government meet together to exchange views.

The private sector relies upon the government to create the legal and policy parameters within which the economy must function. At the same time, it is very important for governments all around the world to realize that business people, operating within a competitive economy, create the wealth and jobs that provide for human progress.

Over the last six or seven years, there has been a global change in attitudes regarding economics. People are coming to realize that private enterprise and individual initiative are the motivating forces that create economic progress. That message is gaining credence in all corners of the globe, somewhat belatedly, I might add.

To illustrate, I would like to read a quote from an article recently published in our Journal of Economic Growth.

We need to permit companies and organizations to sell freely; to buy and borrow from their reserves so as to create a powerful and vibrant goods market; to invest their enormous but idle resources; to unleash in practice, not just in words, economic initiative in the country. In place of fruitless efforts at central planning of our entire industrial production, we should introduce contracts between supplier and consumer.

Now it may come as a surprise to you that this passage is from an article by Nikolay Shmelyov, an economist with the Soviet Union's U.S.-Canada Institute in Moscow. The remarkable thing is that the article was first published in Novy Mir, a prominent journal in the Soviet Union which often serves as an outlet for semi-official ideas that the government wants to try out.

Now, neither the Soviet Union nor the Peoples Republic of China are going to abandon socialism in the near future. But it is very clear that both governments are coming to realize that market-oriented principles form the basis of productive human enterprise.

The conference that we are engaged in today is part of the growing worldwide interest in private enterprise. You will hear from a number of distinguished speakers about the concept of the informal sector or the parallel market.

Now, this is not a new phenomenon. Underground economies have been around for a long time. Traditionally, the informal sector has been seen as a substitute for employment in the mainstream economy. In many cases, government policy was aimed at moving people out of the informal sector into jobs. All too often, it was thought that the best way to do this was to create government-owned firms to soak up excess unemployment or to control imports to allow domestic firms to grow. The result, however, was a decline in growth in the formal sector and an expansion of the informal sector.

Thanks to the work of Hernando de Soto, we now have a fresh approach to this entire issue. Working in Peru with his colleagues from the Institute for Liberty and Democracy, de Soto has published a book that has shaken the status quo in the Americas. I'm sure that it will have the same effect throughout the world once it is translated into other languages.

As with most fundamental discoveries, the genius of Hernando de Soto's work comes from looking at an old problem in new ways. The basic question the researchers at the Institute for Liberty and Democracy asked was, "Why does the informal sector exist?"

Now, you have all read or heard something about

de Soto's famous experiment. Using a team of researchers and economists, the Institute simulated the formation and legal registration of a small firm, actually going through all the steps needed to comply with the various government regulations to obtain all the necessary licenses and permits. It took the team 289 days, working six hours a day, to register the firm legally in Lima, Peru. When the same simulation was repeated in Tampa, Florida, it took three-and-one-half hours.

Working from this very simple illustration, de Soto and his colleagues have spent the last five years demonstrating that Peru's economy is not based on market principles. The informal or extra-legal economy, however, has spontaneously created its own form of market economy. One important lesson that can be learned from the people that make up the informal sector is that market economics is not only for the developed world. As the speakers participating in this conference will show, informal entrepreneurs are found in Argentina, South Africa, Tunisia, and many other countries around the world.

This conference will help put an end to the belief that people in the developing world are not sophisticated enough to operate a market system. This is a belief that has led many countries astray, resulting in an excess of government planning and control. The informal sector's story also shows that open government is essential for economic growth.

Over the last several years, there have been a number of transitions to democracy that parallel the growing interest in market economics. These two trends, market economics and democratic development, are closely bound together.

Later on today, there will be a panel on building grass-roots constituencies for economic change. The speakers will review the types of programs that they have developed to advocate policy change on behalf of the entrepreneurs in the informal sector. That is the real meaning of democracy. People must be allowed to participate in government policy and must be free to criticize or support decisions, not just cast votes in occasional elections.

The group assembled for this conference is one of the most diverse and prominent ever assembled in the U.S. Chamber's Hall of Flags. There are Cabinet officers, senior government representatives, business leaders and scholars from 35 countries present. Your interest and your willingness to travel from all parts of the world are appreciated.

Again, I welcome you, and I thank you for your contributions to this subject, today and tomorrow and in the months ahead.

Dr. Richard E. Bissell
Assistant Administrator
U.S. Agency for International Development

It's a pleasure to see so many people gathered together to discuss a subject of this importance. I just returned from a week's visit to Jamaica and Haiti, where I had an opportunity to talk to people involved in the informal sector as well as in other issues of economic growth. Looking in from the field, this subject seems just as important as it does from here in Washington.

A.I.D. is very pleased to be able to cosponsor this conference on the informal sector with the Center for International Private Enterprise. At A.I.D. we're very interested in private enterprise development. In many countries, that means learning about and working with the informal sector. Just last week, A.I.D. had a conference here in Washington much like this one but whose audience consisted primarily of A.I.D. policy-makers.

On that occasion, we were fortunate to have Hernando de Soto present. He is responsible, frankly, for much of the discussion of the informal sector because of his pioneering work which came from El otro sendero. A.I.D. has been involved in his work for some time.

We hope to learn much in the next few days from Hernando, as well as from the other panelists. Just as important, I want to thank all of you in the audience for coming, in many cases, thousands of miles to be here for this meeting. Certainly, with this kind of interest, I am convinced that we're seeing the beginning of a new way of looking at economic growth. We have now gotten to where we ought to have started - with the ingenuity and enterprise of free people. Today, we recognize that countries don't develop their people but that people develop their countries.

We have certainly been aware of the adverse consequences of the mercantilist economy that was described by Hernando de Soto in his work over the last number of years. A.I.D.'s private enterprise policy is to build up and rely on the indigenous private sector. But it cautions that A.I.D.'s promotion of free markets and the private sector should not be confused with monopoly enterprises, oligarchy or crony capitalism, which have little to do with the free market. This policy is as much a challenge to limited over-regulated capitalism as it is to statist economies. Both limited capitalism and statism have squelched the ingenuity and enterprise of people in too many developing countries.

Economies suffer, and people pay the toll. Prior to World War II, for instance, Argentina was the world's seventh most prosperous nation in per capita GNP. Today it is fortieth. Government regulations are so onerous that they have resulted in an enormous informal sector.

Last July, Maria Eugenia Estensorro of the Institute for Contemporary Studies in Buenos Aires reacted to the informal sector issue in Argentina in an article in the New York Times. I'd like to quote her closing statement:

"The informal economy is a symptom of Argentina's economic woes, not a solution to them. Its presence suggests that growth will begin to recover when people begin to believe that the state is serving rather than robbing them."

It is easy to say that changing government policies is the solution. But we need more than that simple general answer. We need to know which government policies are wrong, and, in fact, these may differ from one country to another. What's more, we need to know concretely why a given policy is wrong and what its bad effects are.

More difficult is the question of how to change policies against the vested interests of an entrenched elite. This will be extremely valuable to A.I.D. in policy discussions that we have continuously with other governments.

Again, I appreciate very much that all of you are here. I know that this is taking valuable time of yours and I look forward to participating in the discussions over the next two days.

PART II

THE INFORMAL SECTOR: ITS REAL AND POTENTIAL ECONOMIC CLOUT

Moderator:	Douglass North, Washington University
Peru:	Hernando de Soto, Institute for Liberty and Democracy
Argentina:	Marcos Victorica, Institute for Contemporary Studies
Discussant:	Robert Litan, The Brookings Institution

The first panel set the stage for the conference by describing the conceptual breakthroughs leading to a market-oriented treatment of the causes of informality. Douglass North of Washington University in St. Louis, Missouri, introduced the subject and acted as moderator for the panel discussion. North is an economic historian whose seminal work, The Rise of the Western World: A New Economic History (Cambridge University Press, 1973), has done much to stimulate new thinking in the entire economics profession about the causes and conditions necessary for sustained economic growth based on his analysis of the historical development of market institutions in Western Europe since the 16th century.

Douglass North

This is a conference about institutions, about the costs of transacting and about economic growth.[1]

When I began to become seriously concerned about long-run economic change, I found that the tools of economics gave very few clues to help understand why some countries had prospered over time and others had not. These economics tools also give very few clues to help understand why there is such an enormous disparity between the developed world and the Third World and why this disparity doesn't seem to be disappearing in any fashion.

Now there's nothing in economics that gives you a clue to that because economics has been a world in which all of the institutions exist, but exist at no cost. It is a frictionless society or, to use the terms that I use, it is a world of zero costs of transacting.

Adam Smith would have turned over in his grave at this idea because long ago he pointed out that the gains from trade arise because of specialization and the division of labor and that you capture these by engaging in efficient organization. Efficient organization is the key to economic growth.

Institutions matter not only because they determine the costs of transacting at a moment in time; they also determine the path of change over time. It is complicated to get efficient markets: it is not a simple phenomena. What is really wanted are: (a) adaptively efficient institutions that maximize the range of choices people have in being able to enter markets and in being able to engage in diverse economic activity; and (b) institutions that punish the losers by getting them out of the market.

This panel will give us an insight into the crucial initial questions: [why it is so costly to conduct economic and business transactions and how the informal sector has dealt with this issue.]

Hernando de Soto

Hernando de Soto is president of the Institute for Liberty and Democracy in Lima, Peru. His major work, El otro sendero: la revolucion informal (The Other Path: The Informal Revolution) (Editorial El Barranco, 1986), has become a best seller in countries throughout Latin America, with over 100,000 copies sold. De Soto has a master's degree from the Institute for Advanced Studies in Geneva. He has been an economist with the General Trade and Tariff Agreement (GATT), managing director of an engineering firm in Switzerland, owner of several firms in Peru and a director of the Peruvian Central Reserve Bank.

The way this all started out for me personally is that after spending a long time abroad in Western Europe, I returned to Peru some eight years ago. I asked myself why it was that others were so wealthy and we were so poor. One of the things that had always shocked me in European and U.S. universities was that the first in the class could easily have been a Filipino, a Pakistani, a Peruvian or a Mexican. Why is it that when we went back home, we went to countries that had different levels of wealth? With this state of mind, we started the Institute for Liberty and Democracy. We wanted to find out why Peru was so poor when the population looked just as prepared for development as any other.

The usual reason given in my country is that the formulas which provided wealth and prosperity for the West are not culturally or ethnically applicable. The whole Inca past and the Spanish tradition are ones that cannot be wed with private enterprise and individual initiative.

The second reason given was political. The problem is that in Latin America, capitalism is peripheral capitalism. It is one that takes place away from the center. Transnationalization of capital, monopolization of technology, and unfair terms of trade make it impossible for capitalism, free enterprise and individual initiative to work. Exploitation is unavoidable.

Well, we were not convinced by these arguments and were very much inspired by Douglass North's analysis. That is, non-economic factors such as legal institutions may be more responsible for economic growth than economic factors. In that connection, the law was one of the major differences between Europe and Latin America.

The interesting thing about the informal sector was that over 50 percent of the population had refused to join the legal institutions of the country. [By studying the informal sector, we could discover what was wrong with the institutions. The informals might provide leads that were not obtainable in any other way.]

The ILD's research found something called the "long frontier." If 50 percent of the population was operating illegally that meant that the formal sector knew about it. There was no way that this could just take place underground. Somewhere along the bureaucratic line, someone in the Ministry of Housing, in the Ministry of Commerce and in other parts of the government had contact with the informals. For ideological, humanitarian or philosophical reasons, or simply due to corruption, these officials were allowing the informals to survive.

By tracing the informals over three years, we were able to meet all of the most important informal entrepreneurs in Lima. Through them, we were able to develop the research and come out with the following results.

- 47 percent of total construction in Lima was outside of the law, with a value of $8.4 billion as a result of direct investment by the informal people in their own homes. This compared with $179 million in government housing programs.

- 95 percent of all public transportation was informal, amounting to a $1 billion industry when repair shops and spare parts are added.

- 90,000 street vendors operated in Lima.

- 331 markets had been built in Lima: 57 by the government and 274 informally by former street vendors. Today, of every 13 markets being built in Lima, 12 are built informally.

The macroeconomic analysis found that 61.2 percent of the manhours worked in Peru were worked illegally or informally, accounting for close to 40 percent of GDP.

One of the complaints about the informal sector is, of course, that it does not pay taxes. However, when we calculated how much tax was paid by the formal, as opposed to the informal, sector, we found that the informal sector gave more revenue to government than the formal sector. For example, just about half of the taxes in Peru come from the taxes on gasoline. Since the informal sector is 95 percent of public transport, it contributes significantly through the gasoline tax. We also found out that there is such a thing as inflation tax. Those who hold large cash balances in a country with 120 percent inflation would automatically allow the government to have extra revenue. Further, street vendors pay a daily tax to the municipal police simply for being on the sidewalk. That tax, in Lima alone, is twice as high as all of the formal property taxes in Peru. In total, between 50 percent and 60 percent of government revenue comes from the informal sector.

The next step was to explain why this was being done illegally. To do this, we used two methods. The first was to simulate the creation of a factory. We set up two sewing machines as a workshop outside of Lima and hired an administrative lawyer and four assistants who went through all of the red tape requirements to register the firm. It took them 289 days, working six hours a day, to comply with the red tape requirements. In Tampa, Florida, the same exercise took three-and-a-half hours and four hours in New York.

The second method was to study the housing situation in Peru. Most Peruvians cannot build when they come to the cities in places allotted for housing since they are poor. They usually opt for building on a sand dune. When we recorded the histories of those who had done this legally, it turned out that it took six years and eleven months, working eight hours a day, to comply with red tape requirements. It involved 207 bureaucratic steps with 51 government departments. Similarly, it took the street vendors 12 years to comply with the requirements needed to start building a market.

We found out that it wasn't only the fact that there are many obstacles to creating wealth - it was also a lack of facilitative law, the lack of some of the institutions that account for the growth of the west. For example, we found out that property rights were very important. We studied over 38 young towns and found that ten years after settlement, the value of homes that had property titles was nine times the value of homes lacking secure title.

We also found out, of course, that it was not only a question of property rights; it was also a question of contracts. To get credit, you need property rights because property rights provide the collateral that allows you to go to the bank. The reason why the poor are not getting credit is the lack of collateral — clear title to land or possessions that allows the guarantees with which banks, both official and private, can function.

Further, if you have a limited liability corporation, you can have a group of contracts to organize a business. You can agree among shareholders how profits are distributed, and you can make deals with third parties. Since it takes 289 days before access can be had to legality, most producers in Peru do not have a formal business organization. As a result, most Peruvians will have to associate with people they can trust, family or friends, because of the lack of enforceable contracts. This has been to the delight of many anthropologists who have visited my country and said, "Peruvians like to work in large families, and they like to work with people they know." But it

is not so much that Peruvians like to work with family or close relations. Good contracts, good property rights and access to the courts are missing in the informal sector.

How is it possible that all of this came about? To answer this, we began looking at the production of law or what could be called "rule-making," and we found out that one of the reasons for this situation is the way laws are made.

In Peru from 1948 to 1985, on average, the government produced 27,400 rules a year -- 111 rules each working day. Further, 99 percent of these rules were produced by the executive branch. We then compared the way law was produced in the United States and found there are three basic ways of producing law.

One way is through common law. In the United States, there are thousands of courts with independent juries, a lawyer and a prosecutor that create jurisprudence. It is very difficult in a system as transparent and decentralized as this to create a norm or custom that means adding to the 289 days of red tape, for example.

The second way of producing law in the United States is through the parliament. The people elected to Congress have to be popular in their own geographical area. Once they sit in Congress, they are continually supervised by constituents. That is why there is an enormous amount of mail between the two. In my country, we have a parliament as well, but it is not the result of popular elections in certain locations. Members are elected by a party list system, so it becomes important to be as high as possible on the list to ensure election. So in the end, the congressman or senator is interested in satisfying the executive committee of his party, not necessarily in satisfying the people who elected him.

Last but not least, we found that the United States also has executive branch law. But the regulators are themselves strictly regulated. Office of Management and Budget rules oblige people putting out regulations to do cost-benefit analyses. There are hearings where different opinions are heard, as well as comment and notice periods.

So, one of our findings is that the reason for Peru's enormous informal sector is that there are no institutions to provide democratic feedback. Our democracies are understood purely as an electoral exercise. We democratically elect a dictator to rule for the next five years. From the moment he is elected until the moment his term is finished, there is no way to control the way rules are produced.

As we continued to analyze our institutions in relation to Western institutions, we found that another vehicle missing is a totally free press. Today, 60 percent of all advertising and 100 percent of credit is controlled by government. Therefore, the press cannot be used as a vehicle to bring information to legislators and politicians. In part, this is because Peru doesn't have systems such as the U.S. Freedom of Information Act and the oversight mechanisms that ensure that the executive branch cannot exceed its power.

Because the critical institutions are not in place, a spontaneous market economy has emerged in Peru and elsewhere in Latin America that is not reflected in the law or ruling philosophy of governments. Therefore, if we start concentrating on institutions and the adjustment of these institutions to reality, we can find peaceful roads to market economies, democracy and prosperity.

Marcos Victorica

Marcos Victorica is head of the Institute for Contemporary Studies in Argentina. He holds a master's degree in economics from the Catholic University of Argentina and is advisor to several financial institutions and a member of several corporate boards of directors. He has held public office as national director and cabinet advisor at the Ministry of Economy. He is a founding member of the Institute.

To begin, I would like to indulge in a moment of reflection. As we know, the Dow Jones index of stock prices recently fell -- some say as a result of the budget deficit. Well, imagine that the Federal Reserve Board could double the budget deficit of the United States with just a couple of resolutions and without any intervention by Congress. Think what might happen. In a few minutes we will see how this is possible, and in fact it has been done in Argentina.

First, I would like to point out that there is a difference between the way the informal economy works in Argentina or other countries in the Southern Cone of Latin America and the Peruvian or other Latin American cases. Argentina, as a country based on European immigration with no indigenous population, is different from Peru with its large indigenous population. In Argentina, there are no cultural differences or barriers that could explain the informal economy.

As a matter of fact, Hernando de Soto talked about the street vendors as a representative part of the informal sector. In Argentina, although we have some street vendors, the most important part of the informal economy are what we call the

"invisible people," people in business suits who work informally.

In Argentina, the informal economy accounts for 60 percent of the GNP. But informality in the industrial sector is about 60 percent of the total as well. That means that informality is not simply a service sector problem but also an industrial sector problem. Today, 97 percent of the informal industrial activity takes place within small and medium industries that employ 93 percent of the industrial work force. Six out of every ten Argentines works partially or totally in the informal sector; 36 percent are self-employed.

The causes of the informal economy are inflation and privileges, public expenditure and regulation, and the cost-benefit equation of the system.

Argentina has the biggest informal economy in the world, as far as the research shows, with 60 percent of GNP in the informal sector. Argentina is also, paradoxically, one of the most inflationary countries in the world since the Second World War. Why?

Well, let me provide an example based on the proposition I made about the doubling of the United States deficit. Here in the United States, it took about a year to give a $400 million governmental loan to Chrysler Corporation. In Argentina, in two weeks, the Central Bank distributed $5 billion to about 150 privileged companies based on simple resolutions. Because of the relationship between our GNP and the U.S. GNP, $5 billion in Argentina represents about $215 billion in the U.S. economy. So that represents a doubling of the deficit in just two weeks through a few Central Bank resolutions.

This example explains how the system in a country like Argentina works and why it is difficult for the people to obtain control over the government. That's one of the major reasons why the informal economy is a way out for people who do not want to pay the bill for all of these expenditures.

There is no accountability in the Argentine case. One or two months ago, the computer system of the second largest national bank burned out. That means that there were no records about credit or loans. At the same time, if you want a telephone, you may have to wait 40 years.

What this really illustrates is that the major problem in an economy like Argentina, where, as I said, there are no cultural barriers, is the cost-benefit equation of the system which determines what you get for your money or for your effort. That problem is clearly illustrated by the fact that Argentina used to be a country with a large immigration but now has started to experience large emigration.

The basic reason why people emigrate is that they ask, "What can I get for my effort and my knowledge in this economy?" In Argentina, they will say, "Well, if I am an engineer or an economist, I probably will have to drive a taxi as well, and with 20 percent monthly inflation, I will never be able to get a savings account, a house or a car." And they say, "Well, with the same amount of effort and knowledge, what would I get in other economies?" Of course, they will get much more.

The same reasons explain 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.

The informal economy in Argentina is absolutely sensitive to economic policy. When you have economic policies that control prices and exchange rates, increase public expenditures, and promote a lot of regulations, the informal economy increases. From the 1960s to the 1970s, the informal economy increased from about 40 percent to 60 percent of GNP. In the 1930s, when Argentina was mainly free, the informal economy was about 20 percent of GNP. That means that the informal economy respond to economic policy.

Another point I would like to stress is the relationship between international debt and the informal economy, two topics that are not usually seen as related. Let me begin with the financial market. In the 1940s, financial assets were about 40 percent of GNP. Now they are no more than 10 percent of GNP. But if the formal financial assets are combined with informal assets, the figure is 40 percent of GNP. This means that the change is not in the total amount of assets but in the portfolio. During the last 40 years, Argentines have shifted assets from the formal to the informal economy.

Argentina now owes $50 billion in foreign debt. At the same time, Argentines have $25 billion in foreign deposits plus $8 billion in overseas real estate and $5 billion in bills owed to us. That means that the average Argentine used more dollars than local currency. In the last three years, Argentina has had the lowest rate of investment in relation to GNP since 1919. Thus, 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.

What is the agenda for integration of the two systems? First of all, I think the most important tool is income redistri-

bution. Income redistribution would not be allowed through the tax system but through the free enterprise system. This involves the liberation of individual creativity, competition, social mobility, property rights, the elimination of inflation as a major channel of privileges, and reorientation of public expenditures toward social aims.

The policies to achieve these objectives are to democratize access to markets, eliminate regulation without cost-benefit analysis, expose subsidies, unify effective tariff protection and reduce public expenditures. Privatization of state-owned companies is another important method. With 500 public enterprises, Argentina is in third place among non-communist countries as a socialist country. Improving standards of competition for state contractors is another important point. For example, the railroad company pays $490 for each guard's uniform while a suit in Buenos Aires costs about $50.

Just as costs are one of the problems, the benefit side of the equation is another problem. The reorientation of public expenditures is very important. For example, in education, public expenditures should help lower-income sectors, quality should be improved, scholarships should be awarded, and investments made in teacher preparation. At the same time, increased public expenditures should be invested in public health, safety and crime prevention.

The consequences of change will be basically two: a real democracy extending the power base in society and a mobilization of the growth forces giving individual initiative and creativity a chance as the dynamic element of the economy.

Robert Litan

Robert Litan served as discussant for the panel to comment upon the presentations by Hernando de Soto and Marcos Victorica as well as Douglass North's introductory remarks. Litan is a senior fellow in the economic studies program of the Brookings Institution, where he is also director of the Institution's new Center for Economic Progress and Employment. Litan is also counsel to the Washington law offices of Powell, Goldstein, Frazer & Murphy, an Atlanta-based firm. He received his law and Ph.D. degrees from Yale and his bachelor's from the Wharton School of the University of Pennsylvania.

I was asked in delivering these comments to expand upon the implications of the informal sector concept for economic development in general. What I would like to do first is get some terms straight.

First, it is a mistake in my view to equate the terms "underground economy" with the term "informal sector." As it is generally used in the United States, the term underground economy refers to individuals engaged in drugs and organized crime. So for example, estimates of the underground economy in the United States, between 5 percent and 15 percent of GNP, refer to criminal activities. When Hernando de Soto and Marcos Victorica talk about the informal sector, they are referring to otherwise legitimate commercial activities such as driving taxis, selling clothes on the street and so forth that are carried out without complying with all of the technical, legal requirements, such as having a license and paying taxes.

The research about "informal activity" raises fundamental questions. For starters, it suggests that for too long, most economic development theories have been far too simplistic. Take, for example, the neoclassical production function approach to economic growth. What this basically says is that you can figure a country's rate of growth somewhat like baking a cake. What you do is you add some savings, some investments, some population growth, some technological progress, and, presto, you know the growth rate of output. Now, countries that have large informal sectors have problems in attempting to make their economies grow. Their savings and investment rates will be well below the optimum level. They will have a severe problem that is entirely assumed away in the neoclassical growth model. That is, their resources will be wasted or used in a highly inefficient manner. For economists, these economies will be well inside their production possibility frontiers.

Now, as Douglass North has shown, capitalism won't work unless some basic minimal institutions are in place. People have to know that their contracts will be enforced and their property protected, either by custom or by a court; otherwise they will trust no one, and they will just engage in activity by themselves. More importantly, they won't invest because if you don't have the confidence to sell anything to anybody else, why even bother to save and invest? In short, as Adam Smith explains so well, economies in which individuals do not specialize in that which they do best will not grow very fast.

Clearly, in the face of these facts, in my view, the challenge to the economics profession and specifically to development economists in the future will be to try to bring some of these concepts into their work. For example, a couple of years ago I worked with some economists at de Soto's Institute, and we calculated that productivity or output per manhour in the informal sector was roughly one-third of that of the formal sector. We further calculated that if you were able to close half of this gap between productivity levels, you could increase Peru's GNP by 25 percent. In other words, you could increase the growth rate at roughly 2 percent a year if you

360

closed this gap in about ten years.

Let me conclude with just a few observations on what should be done to integrate the informal and formal sectors. First, you obviously need to do some negative things such as curtailing excessive regulation, getting rid of red tape; knock down the 289 days that Hernando talked about.

But very important in this negative "laundry list" is trying to reduce interest rate regulation. Interest rate regulation leads to massive distortion of capital. It leads to a flow of resources to large state-owned enterprises and formal firms which probably have lower marginal rates of return on capital. Interest rate deregulation can't be done all at once because of severe macroeconomic fallout, including a diminution of investment and so forth. A challenge to policy-makers is to figure out how to bring about a transition from a world of severe interest rate regulation to a world of deregulation and better allocation of resources. As an example, in the United States, we started with large depositors. We deregulated the rates on these accounts and gradually, over ten years, moved down to the middle class. That may be a model for other countries to follow.

Another thing in the capital market area is to privatize the banking system. They have done the opposite in Peru. A nationalized banking system will suck up all of the scarce capital in the economy, channel it to the state-owned enterprises, fund the federal government deficit, and generally deprive the private sector. That obviously has to change.

There are some positive things that can be done as well. What's interesting about Douglass North's and Hernando de Soto's work is the importance of what they call the facilitative aspects of law -- building positive institutions such as contract, property rights and tort law. These are things that economic development theorists don't even think about. However, these institutions have to be in place in order to have economic growth.

The final point in terms of change is a controversial one, but I'll suggest it, at least for consideration. I refer to the debt crisis, something that Marcos Victorica talked about. Most of the plans that have been offered for dealing with the debt crisis, the Baker plan and the Bradley plan, suggest that the way out is to have debtor countries commit to certain market-oriented reforms in exchange for either borrowing more money or, in the case of the Bradley plan, for debt relief.

Now, I happen to believe that this quid pro quo or conditionality framework, can be used effectively by institutions right now and specifically by the World Bank, which has a large structural adjustment lending program. It could be made to work if the structural adjustment conditions were the quid pro quos that would bring the informal and the formal sectors together. In other words, give more money or debt relief in exchange for reducing red tape, reducing regulation, and showing meaningful progress toward meeting these objectives.

The question I leave with participants at this conference is whether such pressure would work. This is an important topic because it raises the issue of whether you can reform from the inside or from the bottom up or whether you have to have pressure from the outside. Americans tend to believe that you need that pressure from outside, but maybe it can be done within these countries as long as there are people who recognize the importance of making these kind of changes.

Discussion

The main thrust of the discussion session that followed the conclusion of the panelists' remarks was to probe into the solutions to the questions of informality and economic growth. One speaker, for example, pointed out that it was assumed that privatization will generate democratic open-market systems but asked whether it is not more realistic to think that privatization will create more privileges and monopolistic situations. Both Hernando de Soto and Marcos Victorica agreed with the point raised. Unless competition is brought into the system through deregulation, monopoly will continue to exist, and it does not matter much if it is a public or a private monopoly. The key change that needs to be made is to remove the barriers to the functioning of markets.

Another question, addressed to de Soto, was "What are the attitudes toward the informal sector?" In response, de Soto explained that the biggest success his institute had achieved was to draw the distinction between the informal and underground economies, cited by Robert Litan earlier, to show that informals are not criminals. Further, most of the populist political parties viewed the informals as unemployed proletariat, not as entrepreneurs. That view is now changing as the left in Peru comes to realize that they are, by and large, small or microentrepreneurs. Now the left, including the Communist Party, has begun to support the various recommendations put forth by the Institute for Liberty and Democracy. But they tend to think of the situation as similar to that in Hungary or Yugoslavia. The right has not yet become as supportive.

Marcos Victorica was asked, "Is the primary cause of informality poor facilitative law and barriers to market entry?" Victorica explained that in Argentina informality includes 100

percent of the population but not 100 percent of its activities. Everyone seems to engage in both formal and informal activity. There are no clear barriers to get into the formal and informal sectors. It's a problem of profitability and risk.

The last question of the session provided a means for the panelists to offer some concluding remarks on the general trends regarding the informal sector in their countries. The question was "The informal sector is receiving more and more publicity. As governments become more aware of the significance of this sector, is it leading to increased efforts by the public sector to regulate these entrepreneurs, which will force even more difficulty for micro-businesses' development, or is it leading to liberalization of the institutional constraints?"

De Soto responded by noting that both trends are evident. President Garcia recently nationalized the 20 percent of the banks that had been privately held, but he did this in the name of the informals. Although this is obnoxious because the institute does not agree with nationalization, it was an interesting victory because it was the first time that a political party had accepted that the informals were entrepreneurs, not simply unemployed proletariat. Further, the formal private sector just issued a declaration saying that they would join forces with the informals to try to improve legislation that affected the economy as a whole.

Victorica pointed out that in Argentina the informal economy demonstrates that the system isn't working anymore. It is showing that people are voting with their feet against the regulations that created the problem. The informal sector also demonstrates that people have the initiative and creativity to overcome the regulations and restrictions of the system.

Robert Litan sounded a note of pessimism because, in his view, the instinct of government is to clamp down and regulate the informals. Further, the situation arose from rent-seeking behavior, from the iron relationship between government and the wealthy private sector. As Mancur Olson notes in his book, The Rise And Fall Of Nations, the fall of nations is due to exactly this relationship between special interests and government that blocks change. It may take a massive revolution to break this relationship and create change. As asked earlier, will change be possible from within, or will it take some external force, like the World Bank, to create change?

De Soto concluded the panel discussion by offering a rejoinder to Litan's note of pessimism. "I believe that if what we are seeing throughout Latin America is true — that 50 percent or more of the population of our countries have already revolted against the monopoly legislation of the state -- the peaceful revolution that is necessary for change is, as a matter of fact, taking place. All we are doing is documenting it. It has already started."

PART III

GENERATING ECONOMIC GROWTH THROUGH MICROENTERPRISE AND INFORMAL SECTOR ASSISTANCE PROGRAMS

Moderator: George M. Ferris, Jr., *Ferris and Company*

Arthur Levi, *International Finance Corporation*

Nancy Berry, *World Bank*

Kenneth Cole, *Inter-American Development Bank*

Edward Marasciulo, *Pan American Developmen Foundation*

Discussant: William Baez-Sacasa, *formerly of the Nicaraguan Development Foundation*

The second panel examined the role of international institutions in addressing the needs of the informal sector. The panel was moderated by George M. Ferris, Jr., a member of the CIPE Board of Directors. George Ferris is the chief executive officer of Ferris and Company and a former governor of the New York Stock Exchange. He is chairman of the Agency for International Development's Loan Review Board and served as a member of the President's Task Force on International Private Enterprise.

George M. Ferris, Jr.

Having explored the causes and dimensions of the informal sector in two key countries, Peru and Argentina, during the first session, the second panel will examine the attitudes and programs of several international financial organizations toward the informal sector and market economics, in general. Represented here today are the International Finance Corporation, the World Bank, the Inter-American Development Bank and the Pan American Development Foundation. The first three organizations are inter-governmental organizations while the last, the Pan American Development Foundation, is sponsored by the Organization of American States but is a private organization.

The aim of this conference is to demonstrate the potential economic and political influence of the informal sector. However, the long-term goal of all our efforts should be to liberalize political and economic institutions, thus tapping the informals' entrepreneurial energy to promote economic growth in the developing world. I have asked each of our panelists from these international development organizations to address the ways in which their organizations and their programs can help to accomplish these goals.

Arthur Levi

Arthur Levi joined the World Bank in 1973 as a senior agricultural projects officer. In 1983, he moved to the International Finance Corporation where he serves as senior investment officer. Arthur Levi served as a volunteer with the Peace Corps in Kenya from 1964 to 1966. He has a master's in business administration from Columbia University.

When first asked to speak today, I thought that the International Finance Corporation (IFC) didn't have much to contribute to the theme of this conference, which is microenterprises in the informal sector. The IFC doesn't directly support or encourage the informal sector although their activities certainly grow out of some of our investments. The minimum size of an investment in which we can participate is $3 million. Nevertheless, after reading the background information and attending the first session, I have come away with the thought that we really do have quite a lot to contribute to this kind of activity. We are part of the solution.

The IFC was established in 1956 to supplement and work alongside the World Bank in its efforts to stimulate growth for the private sector in developing countries. The corporation's distinctive role and comparative advantage is made possible by two powers given to it, which are not accorded to the World Bank. One is the authority to engage in equity financing, and the second is that we do not accept government guarantees in any of our lending.

The IFC generally invests in projects with a minimum size of $3 million. We can rarely finance more than 25 percent of any deal. Our equity participation is seen as a catalyst. We don't care to have a majority and often don't participate on the boards of the companies in which we have equity. Our equity participation is usually limited to 10 percent. We refrain from supporting activities that are not economically viable, that is to say, those activities that depend for their success on high tariffs or artificially supported prices. Over this past year, we approved 92 operations of loans and equity in 41 countries. We lent $800 million for projects whose total investment cost was $4.3 billion.

The IFC's traditional role in project financing is only part of a much wider role we are beginning to play in the world of private enterprise. In the past several years, our activities have included financing smaller companies through equity lines of credit to development banks, although I must tell you that this has generally not been too satisfactory — there are exceptions — because of how very politicized these development banks are in many countries. Also, we are offering more and more advisory services on a host of different issues. We are presently helping corporations, both on technical and financial grounds, in eight African and eight Asian countries. We also have a government advisory service, which is helping governments increase the efficiency of bureaucracy: decide which kinds of taxes are worth keeping and which aren't; increase the rate at which corporations can register; and handle other issues of this sort.

The needs of IFC countries and clients vary. In sub-Saharan Africa, where private sector development and large investments are limited, we have established two institutions aimed at further promoting private sector development. One is the African Project Development Facility cosponsored by the United Nations Development Program and the African Development Bank. The project has offices in Abidjan (Ivory Coast) and Nairobi (Kenya) to serve small enterprises, those whose investments are generally no greater than $500,000. These offices give technical assistance to make these enterprises more bankable. We have also helped create an African Management Company to provide management support. This is supported, in part, by the Industrial Council for Development based in New York.

What could an institution like the IFC, which frankly is in the mainstream helping large scale enterprises, do? Well,

one thing we can do is to help any of you who are interested in our experience. We have innumerable experiences in every country. I would urge you to use them as a resource to help document your cases. We also offer a very solid engineering department. Therefore, should any of you be involved in promoting or stimulating various sectors, I would urge you to contact the IFC.

Nancy Berry

Nancy Berry is chief of the Industry Development Division of the Policy Planning and Research Complex of the World Bank. From 1976 to 1982, she was one of the pioneers in expanding World Bank lending to small-scale enterprises and industries. In this capacity, she was responsible for developing small-industry projects and components in several countries in Latin America, Asia and Africa. She co-authored the World Bank policy paper on "Small Scale Enterprise and Employment Generation."

First, I'd like say that I am very impressed with the interest in the informal and microenterprise sector that is manifested by the turnout at this meeting. Unfortunately, since I have some controversial things to say, this just may mean that I offend more people than I anticipated.

I'd like to talk about two areas in which I think the World Bank does reasonably well and then about an area which, I would argue, we do not do well and maybe should not do well. The first is small and medium industry lending and assistance. The second is policy change, which I think links to some of the discussion in the first panel on the role of the World Bank and similar institutions in inducing policy change in the regulatory environment. These are two areas that I think we are coming to do reasonably well.

The area which is a weak point for the World Bank is microenterprise and direct links with the informal sector. I will argue a bit later that, by virtue of the nature of large international institutions, it must remain a weakness.

In small and medium industry lending and assistance, the pattern has been quite dramatic. Ten years ago, the World Bank lent nothing to small industry; today, it represents one-third of our industrial lending portfolio. Small-industry programs are active, and we're now on the second, third and fourth series in several countries of Asia, Latin America and Africa. Many of these operations also involve policy reform packages.

I think the bank improved its small and medium industry lending for firms with fixed capital investment on the order of $5,000 to $100,000. We involve the commercial banks, as opposed to the standard government development banks, and build institutional capabilities at the head office and in the branches. We provide attractive spreads to account for higher administrative costs as a percentage of the loan size, insisting on commercial rates. It has been demonstrated that, for small and microenterprise, it really is a question of access as opposed to subsidized rates.

In addition to these credit services, we have moved away from traditional government, technical, managerial and marketing services and into some fairly innovative means to capture private sector expertise. For example, in the case of India, we have adopted a subcontracting approach to encourage the government to release controls on large industry, which had become constraints to both large and small industry, and encourage small firms to move to medium scale through credit and technical facilities.

We recognize that governments often interfere with firms' needs for technical services and a more outward-looking approach in terms of market channels for exports. We have created special funds that are administered outside of the government infrastructure. For example, in Nepal, 300,000 people are employed in the carpet sector in very small microenterprises. Private traders, operating as oligopolies or monopolies, had jacked up the price for wool yarn from Tibet by 200 percent to 300 percent. The World Bank played a catalytic role in forming a local trading company, consisting of the manufacturers, which brought the prices down to competitive scales. In these companies, repayments have been very good. Half of the firms financed were new; half were experiencing modernization. The employment effect has been substantial.

However, in my observation, the World Bank tends to still play too much of a passive role. The Industrial Development Division is trying to find ways to introduce dynamism into the components of bank projects.

The other area into which the bank has put its chips over the last five years is policy change within the macro-trade, industrial and financial sector environments. Comments made in the first panel demonstrate that much of the regulatory environment that governments have set up tend to bolster large-scale incumbents and make it quite easy for them to remain fat and happy, rather than adjusting and responding to changing markets and technologies.

One way the bank has played and can play an increasing role is to demonstrate to governments how the impact of intervention in the industrial sector has many unanticipated and adverse effects, even within their own set of objective

functions. This is the type of work we have undertaken in Argentina, India and Pakistan and have started in Brazil.

It is very difficult to use the leverage of even very large amounts of money to get governments to take actions that they do not believe will have a positive effect. However, it is possible to demonstrate that while governments think they are protecting the small firm, they really are hurting them, as well as consumers, industrial development and the country.

However, while recognizing that the informal sector is very large, this does not necessarily mean that it should be a major focus of attention by international development organizations. First, in major segments of the informal sector, assistance really means, in my view, robbing Peter to pay Paul without any net additional economic return. Second, there is a misfit between the systems and size of many international organizations and the needs of microenterprise.

Local organizational infrastructure is probably the key to assisting small and medium firms and, even more so, to assisting microenterprises where the credit decision really has to be based on character. It is becoming increasingly recognized that micro and small enterprise development may be more complex to manage than large-scale industry.

The World Bank is haltingly becoming involved in microenterprise. We are trying to pair our resources with competent private voluntary organizations that have both the managerial competence to act as a source of managerial and technical assistance, and to play a role in screening potential entrepreneurs. One example is Women's World Banking, a strong private voluntary organization operating in 50 countries. Complementary inputs from, for example, the Women's World Banking network can provide technical and managerial services and credit guarantees that can be coupled with the resources and policy-based components of the World Bank.

In summary, I would say that the World Bank is likely to stick -- in a sustained way, I hope -- to small and medium industry lending, including the use of subcontracting to bring these firms into the global economy. We will probably go slowly in the microenterprise area, as all international organizations should. My observation is that microenterprise initiatives can easily be drowned by too much money. When you do find the organization infrastructure at the local level, you easily find three, four or five bilateral and multilateral organizations competing to lend or grant money to these groups, which is an easy way to drown the kind of organic buildup required for the success of these programs.

Kenneth Cole

Kenneth Cole is the co-ordinator for Programs for Financing Small Projects with the Inter-American Development Bank, where he has held a variety of financial and administrative positions. He assumed his current position in 1979 and is responsible for developing credit projects for low-income populations. Prior to joining the bank, Mr. Cole served with the Peace Corps in Guayaquil, Ecuador, where he developed community credit systems. He has a bachelor of law degree from the University of California at Berkeley and is a member of the California and Washington, D.C. Bar Associations.

First, a quick word about the Inter-American Development Bank (IDB). We are a regional development bank. The African Bank, the Asian Bank and several others are patterned in the same mold. We operate something like the World Bank on a regional basis. We are owned, in our case, by about 43 countries. Most of the IDB's operations are for public works, public sector projects and public policy enhancement, all to the tune of about $3 billion per year.

About ten years ago, the IDB created a special window for financing small projects with some unique characteristics. It has given us considerable experience relevant for understanding the makeup, the problems and the aspirations of the informal sector in Latin America. With the small projects program, we have a facility for making credits on very soft economic terms to not-for-profit private organizations in Latin America and the Caribbean or to special government agencies, which undertake activities for the informal sector.

The small-projects program works with about 160 private voluntary organizations in 22 countries. Through these organizations, we are supporting a variety of activities that enhance income generation and jobs among the low-income groups by dealing with agricultural credit for small farmers and credit for urban microenterprises, cooperatives and associations. Altogether, this makes up about a $70 million portfolio.

Of the $70 million in activities, about $22 million to $25 million have gone into 50 operations just for urban microenterprise. Microenterprises usually have fewer than five employees. Often, microenterprises are mom-and-pop, family-owned enterprises with total assets of less than $5,000. Sales are in the area of $3,000 to $4,000 per month. For the most part, they produce popular goods services for the popular part of the economy. In some instances, there is some vertical integration with the formal sector. One that comes to mind is the situation in Monterrey, Mexico, where microenterprises hand-make molds for the aluminum foundry industry.

Most of our microenterprise projects have some specific characteristics. Usually we look for a private voluntary organization with which to cooperate. We look for organizations that have a business mentality, understand the use of credit and the bottom-line approach to business and yet are willing to risk their time, effort and capabilities in working with very low levels of the economy. We provide credit on virtual give-away terms to the private organization. We expect that organization to deal with the carpenter or shoemaker on commercial terms with real interest rates. In fact, they are dealing with much higher-than-real interest rates and are probably paying 10 percent a day on loans from informal sources. The IDB seeks to ensure that there is some kind of training involved with the application of credit.

When I look over these projects, I am struck by the fact that about 25 percent of the borrowers are women who are managing their own enterprises in the slums of the big cities in Latin America and the Caribbean. I note too, as Nancy Berry mentioned, the tendency for excellent repayment rates among these users of credit. Most of the programs seem to be leveling off at a rate of 85 percent to 90 percent being up-to-date on repayments. Generally, this is far superior to the records of development finance organizations and commercial banks.

I need to add a word about our experience in Colombia because it dovetails with the cautions expressed by the World Bank. In Colombia, we grew from one small project to about 15 with different private foundations in different cities. This multitude of projects became a consulting council that coordinated programs, and developed a uniform computerized data system, and uniform credit regulations and processes. They began a series of friendly consultations with the National Planning Ministry that has now become a national program in Colombia sponsored by the government. It has received a $7 million credit from us which goes through the Central Bank, into the national financial systems, and to the microenterprises with the monitoring and collaboration of the private foundation system that initiated the program. Colombia is a complex model, but we have high hopes that this will work.

To date, in general terms, we have data that tell us that for every $1,000 to $1,200 that goes through these credit systems, we're creating or substantiating a job in the informal sector. Compare that to the $12,000 or $15,000 per job in the formal sector. Considering the funds that we have delivered, we have probably helped create about 15,000 jobs. We've probably trained 20,000 people. More importantly, we have helped strengthen local private institutions in 20 countries. These in turn have helped to educate the public policy-makers in creating the linkages that appear to us to be very important.

Obviously there are major challenges ahead in terms of a need to expand and enhance the delivery system so that the resources that are available can reach the microenterprise level of local economies. That means institution building, linkages with the formal sector and policy dialogue.

Edward Marasciulo

Edward Marasciulo is executive vice president of the Pan American Development Foundation. Prior to joining the foundation, he was executive officer, Office of the Assistant Secretary for Management, Organization of American States. He also held several positions with the U.S. Agency for International Development in Latin America. Mr. Marasciulo has been a visiting professor at George Washington, Georgetown and American Universities since 1977. Most recently he served as lead consultant on social and humanitarian concerns for the Bipartisan Commission on Central America (Kissinger Commission).

I think that it's important to explain what motivated the creation of a private voluntary organization like the Pan American Development Foundation (PADF). Twenty-five years ago, during the era of the Alliance for Progress, Sam Green, a businessman from the U.S. living in Guatemala, along with a number of his colleagues, became aware that the Alliance was only reaching 10 percent to 20 percent of the people of Guatemala. His assumption was that this problem was widespread throughout the hemisphere. He was very much concerned about the disenfranchised, the 80 percent of the population with no access to credit who are, generally, spectators of the process of development and, in his view, the motivators of the guerrilla movements that have since developed.

For those of you who remember this era, you also remember that it was a period of time when the development economists were pushing the ideas of the Harrod-Domar model and the Rostowian theory. It was also an era when the development economists began talking about structural change, when the economists were not yet talking to the anthropologists or to the political scientists. What the PADF created was an anathema to the concept of planned development.

Today the Pan American Development Foundation is not the only player in the activities that I am going to describe. There are many other organizations like ours. I mention specifically Accion International in Cambridge, Massachusetts. They're a rather outstanding group, and they have done some rather significant things throughout the hemisphere jointly with us. So, the not-for-profit community is rather sizable

these days. It wasn't 25 years ago. What is lacking these days is an inventory of all of the players in the development business in microenterprise activity.

What did we find during our experience? We found that these men and women who previously had no access to the banking system because they had no collateral were exceedingly good credit risks. We found the need in many cases to take people by the hand into the bank because they had no ability to deal with the structure of the bank or to even open a bank account. Therefore, we found that it was not only credit that had to be injected into the system. And we found that the trainer had to be, in most cases, the local formal sector. So we found the need to link what we now know as the informal sector and the formal sector.

PADF had no model; indeed, we still have no model. We all learned together, and we have found that every one of the foundations that we have helped to create, 31 over the last 25 years, is different. Each one has its own idiosyncrasy.

What have we learned? We've learned that the informal sector must be used as the link, and the source of credit must be within the formal sector itself. We have found that the formal sector has a process to learn about within its own society.

I have often used the example of San Pedro Sula in Honduras. In the north coast of Honduras in the early 1980s, guerrillas came into a meeting of the chamber of commerce and held 100 of the members hostage. They spent three days with these guerrillas and went through the process of the Stockholm syndrome. They found that, indeed, the guerrillas had a philosophy and a concern. Outside the chamber were members of the very strong labor unions on the north coast of Honduras who had demonstrated against the guerrillas and in favor of those who were being held hostage inside. It was through the demonstrations of those labor unions that the hostages eventually left the country. From that experience, the formal sector of San Pedro Sula, which is well-known for its progressive activities, created a foundation with a portfolio of roughly $5 million. They now have their own formal sector very much involved in the concern of what we might want to call the enterprising poor. They see it as being for their own security and for their own future.

This is not a unique experience. The same thing happened in Jamaica when Seaga came in as Prime Minister and recognized the quick political change in that environment. One of the first things the government did was create a national development foundation as a means to provide credit to the informal sector through the management operation of the formal sector itself. It now has five branch offices throughout the island.

So our concern is not just a matter of economics, nor is it solely a concern for job creation. In many ways it's a concern for survival, and I think the survival mechanism is just beginning to explode throughout the hemisphere.

There is a growing need and desire for the creation of private organizations in the hemisphere well beyond what we had expected 25 years ago. There are many links with private organizations in the U.S., but our goal is to build a local foundation run by the local private sector. I daresay it will be happening more and more over the next 25 years.

William Baez Sacasa

The discussant for the program was William Baez Sacasa, a consultant to the Pan American Development Foundation and the Cooperative Housing Foundation of Washington, D.C. From 1970 to 1985, he was the chief executive officer of the Nicaraguan Development Foundation and the Nicaraguan Development Institute. He is author of the Informal Sector in Latin America: A Preliminary Overview and Nicaragua: The Informal Sector in Transition. Mr. Baez has served on the board of the Superior Council of the Private Sector (COSEP) in Nicaragua and the Pan American Development Foundation. He graduated cum laude from Holy Cross College, Worcester, Massachusetts.

I would like to take issue with what was said this morning and what is being expressed by our panelists this afternoon. For the last five years, as a member of the private sector and as a development agent, I have felt that there are two types of models that have been developed to assist the microentrepreneur or the informal sector.

One model is expressed very clearly in Hernando de Soto's book, El otro sendero. It characterizes the informal sector as a group of individuals who are at the margin of the law. The way to approach the problems of informality is to help these individuals overcome the regulatory barriers to make the informal sector more formal or the formal sector more informal. The stress is on the need to change the law and politics of the country, which is very important.

This afternoon we have seen what I consider to be another model, which has stressed the importance of the microentrepreneur, or what Ken Cole has called micro-business. This model, which has been developed over the last 25 years by the Pan American Development Foundation, has been

adopted by many different organizations. It has stressed the credit, training and technical assistance aspects of development. To foster this type of model, significant funds have been given, over the last 25 years, through the World Bank, the Inter-American Development Bank, the Pan American Development Foundation, ACCION International and the Inter-American Foundation. The emphasis has been on the importance of the individual as a businessman: to try to move him from a small to a larger businessman.

What is very important is to complement both models: to put them together and create a single model that will address the problem of informality from the legal aspect and the micro-business or credit aspect.

In Nicaragua, we conducted a study with the help of CIPE about two years ago called "The Informal Sector in Nicaragua: An Alternative Solution". We tried to pull the two models together and find out how the informal sector behaved in a very special situation like the case of Nicaragua. Under very extreme situations, like Nicaragua, the informal sector shows its true colors or characteristics. We found that it doesn't matter that the informals live in a culture of collectivization; in the final analysis, they are entrepreneurs. They are highly motivated; they want to make profits.

If we want to stress democracy and pursue the happiness of our people, especially in Latin America, we have to cope with the problem of giving people an opportunity via the legal system, as Hernando de Soto has said, and via the credit aspect as discussed previously. A true democracy is not only voting but is a day-to-day process.

How can we strengthen and promote the informal sector? First, it's important to identify the informal sector — who they are, where they are, what type of things they do. Identification is one element.

The second element is valorization. Small entrepreneurs are important. It's important that we believe that they are people who have the willingness and the courage to fulfill their own lives.

Third, we have to stress the importance of organization. It's very important to go into the legal aspect, but it's more important to organize the informal sector for political, economic or sociological ends.

Fourth, we have to understand that there has to be a linkage between the informal sector and the private sector or between the microentrepreneur and the entrepreneur. They have to believe and understand that they belong to one private sector in order to sustain democracy in the countries where there is still democracy. In order to fulfill the dream of democracy, you have to strengthen not only your companies but you have to provide for the strength of the informal sector.

Another important element is understanding. They need training; they need credit. They don't need it the way we traditionally do it: coming from upstairs to downstairs. In the Nicaraguan Development Foundation, we hired a loan shark to tell us how to provide credit to these people. We have to work with the idiosyncracies of the people.

The most important part, as mentioned before, is the legal support that we have to provide through regulatory reform to make the formal sector more informal and the informal sector more formal.

I have addressed the two schools and how they can be joined. In Nicaragua, the situation has changed; it is now more difficult. But I want to express this view because I know that many of you come from democratic countries. I want to leave you with the message that the informal sector is a very important element in the democratization of your countries and in sustaining the lifeblood of the private sector.

Discussion

Questions to the panel tended to focus on the issues of regulatory reform and the manner in which these multilateral development organizations carry out their lending programs. Given the constraints of time, the moderator grouped several questions together and asked the panel to respond.

The first group of questions focused on the theme of regulation as stated in the following: "If over-regulated economies in states controlled by special interest groups are causes of informality, then how do microenterprise programs help address the causes of the problems?"

Nancy Berry responded by indicating that she shared the view that it is much more important for international organizations to try to influence the overall legal and policy system. She also felt that the policies had to go beyond getting the exchange rate right by getting into the policies, particularly in the industrial regulatory area, that are restricting internal competition.

Ken Cole agreed and indicated that he hoped that as the World Bank and the IADB approach structural adjustment, they will take into account not just needs for housing, roads and services but also look at what is needed to provide market

conditions for informal jobs and products. Cole also noted that the banks should be looking at the potential to mobilize savings in the urban sector as it relates to the informal sector activities which, as noted, are between 40 percent and 60 percent of GNP. This would also require looking at the regulatory environment in the banking sector that impedes their ability to lend to microentrepreneurs.

The second group of questions focused on the manner in which multilateral organizations carry out their lending. One question was about the need for subsidized lending and a second about the possibility of bypassing government-to-government lending programs. Conversely, the third questioned the usefulness of lending through private voluntary organizations.

Edward Marasciulo responded by noting that those in the development community tend to look at development in terms of government-to-government programs but that what is really needed is to find ways of using the private sector as an agent of change. The governments control these lending institutions, and unless you can break the government-to-government relationship, the activities dealing with the private sector won't function.

Nancy Berry added that the panel was agreed that lending to microenterprises should be at commercial rates since they can pay commercial rates and that they normally, without some type of program, pay more than commercial rates. She also argued that governments cannot be bypassed since they tend to be a major part of the problem in terms of industrial and financial regulations. The challenge is to structure lending operations in such a way that you deal with the overall policy environment. With respect to private voluntary organizations, Ms. Berry cautioned that it's important to find groups that operate with business objectives and have the appropriate managerial and organizational apparatus to be an appropriate grass root creditor/technical service intermediary.

370

PART IV

BUILDING GRASSROOTS CONSTITUENCIES FOR ECONOMIC CHANGE: APPROACHES

Moderator:	Jose Luis Yulo, Jr., Philippine Chamber of Commerce and Industry
Peru	Hernando de Soto, Institute for Liberty and Democracy
Paraguay	Martin Burt, Paraguayan Foundation for Cooperation and Development
Argentina	Adolfo Ruiz, Institute for Contemporary Studies
Brazil	Dr. Joao Geraldo Piquet Carneiro, formerly of the Ministry of Debureaucratization
	Luis Eduardo Magalhaes, Chambers of Commerce of Sao Paulo
Discussant:	Edward Hudgins, Heritage Foundation

The topic of building grassroots constituencies for economic change was split into two parts for convenience of presentation. The first part focused on various private and public sector programs designed to remove the causes of informality. The second part of the panel, reported in the next section of this booklet, sought to determine if these experiences can be replicated in other countries, particularly outside of Latin America.

The moderator of the panel was Jose Luis Yulo. Mr. Yulo is vice president and founding charter member of the Philippine Chamber of Commerce and Industry and is the managing director of the Philippines Center for International Trade and Exhibitions. He is also a board member of the Lokalota Sugar Central, the Rural Bank of Mactan and Unitrust Bank. Mr. Yulo received his master's in business administration from the Asian Institute of Management, has taught at the de la Salle Graduate School of Business, has written several books, and is a regular columnist in various Philippine newspapers.

Jose Luis Yulo

As I listened this morning to Hernando de Soto's description of the informal sector of Peru, I thought for a moment that he was a Filipino, for he struck many a nerve in my system. I am sure that each of you here today identifies with him not only because he has given impetus to a new, conscious effort to study the informal sector which exists in all of our countries but also because of the intriguing potential and power that the informal sector can unleash.

In the first session this morning we tried to get a better understanding of the concept of the informal sector, or, shall we say, the "black market," the "black economy," the "underground economy," the "parallel market." I think the name we call it depends on how diplomatic we want to be and the personal, cultural preferences of each country. In the second session, we examined some assistance programs that are now available to the informal sector and microenterprises. It appears that some of these assistance programs need adjustments, if not outright changes, to better interlock with the informal sector.

Now in this session, we shall discuss ways and means to change institutional structures, policies, laws and regulations, if need be, in order to harvest the full potential of the informal sector. As an example, during the 1960s, the Philippines was second only to Japan in economic advancement in our part of the world. After going through a strong statist government, we ended up somewhere near the bottom. Current estimates by our National Tax Research Center have shown that about 44 percent to 47 percent of our economy is underground. The Bureau of Internal Revenue, when it tried to flush out the underground economy in one district of Manila, raised its revenue collections by 293 percent from the previous year.

With the new era and a new democratic government, we have come up with new directions such as dismantling monopolies in sugar, coconut and cement, to mention a few; the dismantling of crony capitalism; and the ushering in of privatization coupled with government deregulation. This has resulted in lower interest rates, lower inflation and the reversal of economic decline. This economic growth has occurred in spite of negative press releases and in spite of the persistence of some political pretenders to President Cory Aquino's position.

Worth mentioning as a program to try to build grassroots constituencies is a project that the Philippine Chamber and CIPE have worked on together. It is a project aimed at the promotion of business advocacy in the outlying provinces of the Philippines. The intention is to strengthen local chambers of commerce and industry in the different provinces, and by so doing, use these chamber organizations to service not only microenterprises but also the informal sector.

The project is composed of four important components. The first is to identify about 20 potential speakers in a local community and put them through a spokesmen's training session so that they can relate to government, to the military, to religious groups or others.

Second, we have instituted a regular radio business program because radio is the more important medium of communication in the outlying provinces. Third, we have also instituted a mass publications campaign to inform the private sector and the informal sector in the provinces. The fourth element was to build membership in the chambers, which has increased tremendously, drawing some informal sector business groups into membership in the chamber of commerce. Because of these endeavors, we were able to establish about 50 local chambers of commerce all over the Philippines.

We have worked out a corollary project with the International Labor Organization called the IYB, for "Improve Your Business." In this project, we again identify about 20 small businessmen and help them improve their business to ensure their profitability and existence. Now, if the IYB program is simplified, it can be brought down to the level of the informal sector.

Hernando de Soto

Hernando de Soto is president of the Institute for Liberty and Democracy in Lima, Peru. His major work, El otro sendero: la revolucion informal (The Other Path: The Informal Revolution) has become a bestseller in countries throughout Latin America, with over 100,000 copies sold. De Soto has a master's degree from the Institute for Advanced Studies in Geneva. He has been an economist with the GATT, managing director of an engineering firm in Switzerland, owner of several firms in Peru and a director of the Peruvian Central Reserve Bank.

The objective for this session is to discuss building grassroots constituencies for economic change. I think this is a very appropriate title, at least for what we're trying to do in Peru. Our objectives, as you know, are to achieve development through a democratic system and a pluralistic or open market. These were the formulas that the Western democracies used to achieve the highest state of prosperity known to mankind.

Now, what we're seeing, at least in Peru, is similar to what we saw some 200 years ago in Western Europe. Capitalism is a very old thing. It existed even in the times of the Borgias in the north Italian states. But at that time it was called mercantilism and was reserved to a very few people who had the privilege of associating with a state, generally run by princes or royalty, which gave them the right to practice entrepreneurship. This system of mercantilism started falling apart when large migrations took place in Europe from the countryside into the cities. The people who arrived in the city were not pleased with the lack of opportunities. Due to both their frustrations and rising expectations, the law lacked legitimacy.

In those days, to form an enterprise, you needed a special charter from the king. Until the middle of the 19th century, only about one-sixth of all British people could actually form enterprises. However, during the 19th century in Europe, mercantilism was transformed into what are today the Western European democracies. These are the countries which managed to solve the contradictions of capitalism by making sure that entrepreneurship was open to all so that all could identify with a system of free trade, democracy and open markets.

We feel that this is now occurring in Peru. In effect, as a result of the mass migrations from the countryside into the city, large segments of the population have been impoverished over the last years; people have not seen the economic growth that some Asian countries have witnessed, and they are frustrated and need an explanation of why things are wrong.

We have been very successful in showing the informals that they are entrepreneurs but have not been successful so far in convincing them to identify with the private formal sector. As a matter of fact, to write the book El otro sendero, we conducted interviews with over 80 informal sector entrepreneurial chiefs. We asked them three basic questions. First, we asked, "Are you the private sector?" And 79 out of 80 responded, "no." When we then asked, "Are you the public sector?", they said, "Of course not, the public sector is government." So we asked, "Then who is the private sector?" The reply was "Those up there: the oligarchy." So we have a large private sector - an informal one - that does not identify with the private formal sector.

To try to build grassroots constituencies, the ILD in Peru has organized a system which we call "everyone's balcony."2 It's a private ombudsman system whereby we raise public issues on behalf of the informal sector. One example that I mentioned in the first panel is titling. The government has only managed to build one out of every fifty homes that have been built by the informal sector, and these government-built homes are costlier and smaller than those built by the informal sector. Since most people don't have clear title to their privately-built houses, we need to affirm the informal sector's rights as property bearers to have title to their homes and land, rather than to build more government housing.

We drew up a piece of draft legislation to improve the process of providing the informal sector with titles to land. When we presented this draft law to the public during one of our public sessions, we managed to get 300,000 signatures in less than one month in support of our draft law. We then published this draft law in the official gazette of Peru called El Peruano. With 300,000 signatures backing it up, President Garcia had no choice but to support the law, which he did pass — though in a rather modified and inefficient form.

We have had similar successes since then. When we have talked about removing rent controls from the informal sector in the country, we managed, in one day alone, to get 176,000 signatures. In the case of bus and truck drivers, we managed to get 310,000 signatures in support of proposals to simplify regulations.

We had an extensive debate with the communist municipal government of Lima when they brought out an ordinance which tried to organize the street vendors. When we pointed out that the law was not very modern - five out of every six articles in that law were contained in ordinances of the viceroys over 150 years before - we managed to actually defeat that ordinance. In a communique, the street vendors came out in defense of the institute's position. Actually, 111 out of a total of 120 street vendor organizations in Lima supported us.

Every time a point of conflict arises which interests the informals, we communicate with them through a system of pamphlets, radio advertisements, television, debates and hearings. We interpret their positions the same way the Marxists would but in terms of producers versus the state, not of rich versus poor. The result, of course, is that we are using Marxist systems to communicate ideals that they do recognize and with which they identify.

We had our most glorious proof of success in connection with a project in San Martin de Porres. San Martin de Porres is an area in Lima of 500,000 inhabitants that is run by one of Peru's most radical, extreme-left parties called the PUM. The town council, including the mayor, came to visit us. They asked us to set up a mechanism of governing which would allow the introduction of a market economy and democracy the way we had outlined for the national economy and the national government. Of course we used a very different name for a market economy. I think we called it government action for a popular economy. Instead of talking about entrepreneurs,

we talked about free workers. We used all of their language to establish the internal legislation necessary for a private economy and an open, democratic system.

Once this system was publicized the executive committee of the Communist Party got hold of it and the mayor was forced to make a public autocriticism. All of the PUM council members in the municipality then resigned in disgust because of the pressure from the Central Executive Committee of the Communist Party. They are now actually working in the Institute for Liberty and Democracy.

This indicates that communists, at least in Peru, are ideologically soft. What they want is change. What they know is that they are basking in poverty. They are frustrated and want an explanation and a formula on how to end their frustration. The common denominator is change. Whoever can provide change can win their votes and their support. The important thing for them is not statements; it is action. That is why we continually try to come out not in defense but as enemies of the status quo.

Poor people are not satisfied with things as they are. If you identify, at least in the case of Peru, with things the way they are, you will have the informals against you, even if they are entrepreneurs. But if you support change, there is absolutely no reason why they will not fully identify with their status as progressive entrepreneurs. It is extremely important for those organizations that represent business to come out in defense of the informals. The formal private sector must fight against the obstacles which informals face, not only against the obstacles which they themselves face. When that happens, informal entrepreneurs will identify with formal entrepreneurs. We will then have reversed the revolution that the communists want to make.

We will only have a successful entrepreneurial revolution when we all clearly come out in defense of the poor entrepreneurs, who have no opportunities, and against a status quo which is not yet a market economy and a full democracy.

Martin Burt

Martin Burt is executive director of the Paraguayan Foundation for Cooperation and Development. A native of Asuncion, Mr. Burt graduated from the University of the Pacific in Stockton, California, with a degree in public administration and inter-American studies. Mr. Burt also has degrees from the Instituto Nacional de Adminstracion Publica in Spain and from George Washington University in Washington, D.C. He is co-author with Guillermo Peroni of Paraguay: Laws and Economy and has served in the Ministry of Commerce and Industry.

The Paraguayan Foundation for Cooperation and Development is a new organization, two-and-a-half years old, whose main objective is to increase family income, strengthen precarious jobs, and create new job opportunities by organizing microenterprises into solidarity groups. These solidarity groups eliminate the problems that banks have in lending to the very poor people by analyzing the microenterprises' capacity to pay. The solidarity groups guarantee the loan so that if one member fails to pay, the group pays the loan. In two-and-a-half years, we have given out loans to more than 2,000 small businesses, and we provide technical training as well.

As you may know, Paraguay has been ruled by one government for the past 33 years. The difficulties in working under that system are very significant. When we tried to organize a program to give credit to very poor people, we were told that it couldn't be done. We were told that you could not organize solidarity groups because Paraguayans were all individualistic people who would never organize into groups. We were told that the government would never allow us to operate, that we could never get funds to do it, that we would end up in jail for trying to organize these people, and that a foundation could never work in Paraguay.

A quick analysis of the external environment when we started this program told us that we faced four very serious threats: political, governmental, business opposition and a very weak financial base.

First, politically, in Paraguay it is illegitimate to organize the poor. It is a highly politicized environment. Any attempt to organize the poor or to work with the informal sector is seen as either a communist or opposition plot against the government. We have seen severe police repression in reaction to efforts to work with the informal sector.

On the government side, we needed President Stroessner's signature to allow us to open the foundation. We had to go through a series of security checks to get the bureaucracy to accept our bylaws, so we had to word our intentions in a very specific way. We had to create a board of directors of key people in the community because, in Paraguay, who is involved is more important than the objective or motive.

With respect to the business community, in Paraguay, as in many other Latin American countries, we have a very conservative business sector. They are reluctant to join the board of directors of a project that they may see as having political intentions. If they are going to support a social responsibility program, they would rather join a charity than work with a modern development organization.

The fourth threat that we faced was a very weak

funding base. In contrast to what the World Bank representative said, there are very few international donors working in Paraguay.

If you are going to build grassroots constituencies for a particular cause, you have to concentrate on building internal strengths. You have to start with a very solid feasibility study and recognize the strengths and weaknesses of your organization. You have to obtain solid legal advice, and you also have to surround yourself with prominent international auditors to show that you have transparent finances. You have to be able to develop, at least in our case, a very large loan and training scheme because the big question for a microenterprise project like ours is whether you can give out the money and get it back.

Once we had developed a program to reach thousands of microenterprises with loans and managerial training, we developed, with CIPE funding, a twin strategy. One was to educate the people on the importance of the informal sector, and the other was to strengthen and build linkages between the formal and the informal sector. I will explain briefly what our message was, the specific strategies that we used, and the tactics and the methodology.

The message that we used was very carefully worded. First, we indicated that it was valid for the private sector to pursue development objectives that were previously only in the public sector. We wanted to convince people that we were going to pursue these objectives by freeing the forces of small business and not by public enterprise. The second point was that it was valid for a private development foundation to do this. In Paraguay, there are very few foundations.

For the government, we produced a message that we were not communists or in the opposition. In exchange for us not politicizing our project, we insisted that they not politicize our project either. Basically, we communicated this point to ministries and members of the police by telling them, "If you politicize the project, the project will fail, and you will not have a system to create jobs. So it is up to you to let us proceed."

We told the local community that we were not married to the government, even though we dealt and worked with the government all the time; that we were not crony capitalists; that we were not trying to promote individualism and selfishness, but we were trying to create solidarity groups and associations of microenterprises to organize the poor; and that we were not just a loan company, but we were creating new skills. We relayed that message on a daily basis. We created a media office in the foundation whose objective was to have the foundation message in one of the 22 radio stations, one of the four newspapers or one of the two television channels every day.

We made extensive presentations to the public sector, including the various ministries and offices and to the private sector business organizations. We then went to talk to the bishops; of course, we were not talking about capitalism but about programs for the poor. All of this involved specific planning. We had to identify each group very carefully and define why that group was important. We held preliminary meetings with contacts that we had in each organization, and we prepared each presentation in the group's language. We tried to show that each group's interests would improve by promoting small enterprise and the informal sector.

The methodology included round-table discussions. Dialogue was important because every person in Paraguay has had at least one experience with small business. We took business leaders to these presentations, not young social activists. We have used advertising companies to help make the presentations and a formal evaluation company to conduct before-and-after interviews to measure the impact with the target groups.

Another strategy was to strengthen linkages between the informal and formal sectors. We had prominent business people, such as Amaury Temporal, head of the Brazilian Chambers of Commerce, speak to our business groups about the informal sector. We also created new microenterprises organizations such as the Hairdressers' Cooperative and the Forum of Microenterprises.

I would like to finish by saying that it is possible to educate the public on the importance of the informal sector and it is also possible to create linkages between the formal and the informal. We have helped revolutionize the financial and development circles. We have been able to reach thousands of poor people with massive amounts of credit and training by incorporating the concepts of informal economy and microenterprise, even in a country like Paraguay. We're doing this because we think that by democratizing private property, we may achieve liberty.

Adolfo Ruiz

Adolfo Ruiz is communications advisor to the Institute for Contemporary Studies of Buenos Aires, Argentina. He received his degree in marketing from the Foundation for Advanced Studies of Commercial Sciences. Mr. Ruiz is a vice president of Manpower Temporary Services, Argentine Branch Office.

In describing the Institute for Contemporary Studies' approach to grassroots action, I will concentrate on communications. Marcos Victorica has already described the research

findings of the Institute's studies on the informal sector in Argentina in the first panel.

In the communication area, we considered four aspects: first, communication objectives; second, the strategy of communications; third, tactics; and fourth, refining the strategy.

When the research was completed, our first step was to identify three marketing objectives in reference to the informal economy. Above all, we wanted the main decision-making segments of the population to associate our institute with the informal phenomenon.

Our marketing objectives were as follow: first, to explain that economic informality in Argentina is distinguished as much on a vertical as a horizontal dimension; that is, informals are not simply small firms. Our second objective is to halt the decline in prestige of legislative processes and the consequent weakness of participatory democracy. Third, we sought to communicate the diagnosis and treatment of the phenomenon to the diverse social groups that are affected, often without their knowledge, and which would support demands for elimination of the causes of informality.

Over the last year and a half, our strategy of communication has been oriented toward two ends. First, to unify the terminology. As happens in numerous countries, the informal economy in Argentina is subject to various terms: "black economy," "parallel," "underground," "subterranean," "submerged," "invisible," etc. Thus the task was to apply a universal term and, at the same time, extricate the phenomenon from the aura of illegitimacy that surrounds it. We believe that we have achieved this objective since the term "informal economy" has entered into general usage in the majority of communications and documents from public authorities and in those from private institutions and political parties.

Second, we wanted to publicize the magnitude of the phenomenon. For the first time, there are documented reports that confirm the impression that the informal economy is widespread and has penetrated all socioeconomic strata. Again, we are persuaded that we have achieved this objective. Today we can affirm that a large number of Argentine leaders have become conscious of the issue's magnitude and consequences for societal behavior.

The tactics we used were based on selecting highlights of our research and translating them into common language. Thus, we prepared a group of basic texts, taking special care to avoid repeating messages between each newspaper and magazine. We selected mass media with readership among decision-makers and groups of opinion coalition-builders. After this, we began contacting journalists, politicians, and public officials.

The fourth step was to refine the communications strategy. Having been able to surface the issue within socioeconomic debate, the strategy of communication had to accomplish another objective: to avoid a potential detour in public opinion currents toward policies which persecute informality instead of removing the causes of informality. To do so, we identified those most affected by the informal economy and who, therefore, constituted its principal detractors. When we say this, we should not forget that those in the informal economy are also suffering from the effects of the formal system. Our strategy was to capture those sectors within the official economy that can be transformed into allies in the fight against state interventionism, mainly those that are not recipients of state favors and privileges. But it happens that many of these groups either are not aware that informality is affecting them or do not clearly understand how it is happening.

Up to this point, our investigation has been based on macroeconomic criteria, and therefore we have only partial knowledge of how informality permeates specific segments of the economy. Therefore, the next step will be to develop microeconomic criteria to approach subsegments to inform them precisely about the type and character of phenomenon that is affecting them and, above all, to present them with proposals for the removal of the causes of the informality and for the integration of the economic system. The segments and sub segments that we will select are the 500 leading enterprises, multinational corporations, businesses that call out for change, export and trading companies, business-sector chambers, professional associations, trade unions and universities.

We are persuaded that, with a thorough knowledge of these sectors, we shall succeed in our task of contributing toward a more integrated and, above all, a fairer economy since the state would not then be the arbitrary distributor of exclusive privileges.

Just as when the sun becomes unbearable we seek shade, in the same manner, when the weight of the state becomes unsustainable, the only defense of the silent majority is the informal economy.

Dr. Joao Geraldo Piquet Carneiro

Dr. Piquet Carneiro is a partner in the firm of Gols, Piquet & Lobo, specializing in political risk analysis and strategic planning. As an attorney, he specializes in taxation and commercial law. Dr. Piquet Carneiro graduated in law from the Federal University of Rio de Janeiro and completed postgraduate work in comparative law at New York University. He was professor of economic law at Catholic University and in Rio de Janeiro. In 1980 he joined the National Deregulation and Administrative Reform Program and in 1982 was appointed executive secretary. In 1983 he replaced former minister Helio Beltrao as its coordinator until the end of his term.

Perhaps the most useful contribution that I can make to the objectives of this conference is to to share with you my personal experience in connection with the Statute of Microenterprises enacted by the Congress in 1984. A few words about the National Debureaucratization Program are necessary for an understanding of the circumstances under which this statute was conceived. The scope of the program instituted in 1979 was to reverse the trend toward unnecessary growth of the bureaucracy of the state and widespread inefficiency in government. This trend resulted from three ingredients in Brazil: namely, excessive centralism; rigid formalism; and generalized distrust by government bureaucracy toward society. That's what we call bureaucratization.

Naturally, poor people and small companies are the first victims of excessive bureaucratization. Thus, priority was given to the Citizens Project, a complete survey of all points of contact of individuals during their lifetime with bureaucratization requirements, and the Enterprises Project, a similar survey with respect to requirements imposed on the pre-organization and organizational stages of private companies, as well as on their day-to-day existence.

An overall attack on bureaucratization in the early stages of the program would certainly be a failure in view of the magnitude of the resistance it would encounter. For that reason, we felt it absolutely essential to adopt a gradual approach to debureaucratization in order to gain public and political confidence and support.

When the program started, virtually all commercial and industrial companies, regardless of their size, had to keep and fill in at least 13 different accounting and tax books, file complex income tax returns every year, and comply with a series of government formalities. In 1980, through the program, full income tax exemption was granted to companies with annual gross income not in excess of $3,000, thereby benefiting 230,000 companies out of a universe of 1.7 million active companies at the time. Federal excise tax rates applicable to products typically manufactured by small companies were reduced to zero, and payment of corporate income tax based on assumed profits was extended to companies with an annual income equal to or less than $1 million a year. In all three cases, maintenance of accounting records related to these taxes, preparation of balance sheets and filing of income tax returns were abolished. This was not at all an easy task.

In the beginning, the Federal Revenue Department strongly opposed some of these measures for fear that exemption might lead to tax evasion. Since these exemptions would amount to less than 2 percent of the estimated tax revenue in 1981, our contention was that there would be no decline in revenue. On the contrary, the government would benefit from rationalization of its collection and inspection mechanisms. Two years later, the Minister of Finance raised the level of annual gross income for income tax exemption purposes in light of the fact that there was no real decline in revenue. Thus, approximately 40 percent of registered active companies were relieved from federal taxation and related bureaucratic obligations.

In 1981, a bill was enacted to simplify drastically the act of organization of companies. Century-old formalities were abolished, the paperwork load was substantially reduced, and cumbersome controls were eliminated. Organization of an individual firm or a limited liability company, 97 percent of all registration applications, used to consume three to six months to be completed; it is now obtained in 48 hours. In Brasilia, the registration takes 45 minutes.

The cost of organizing small companies became symbolic, and the services of lawyers and expediters were no longer necessary. Adverse reaction came not only from the bureaucracy but from professional groups as well. Lawyers, a very powerful group in Brazil, felt that they were losing a share of the market. Accountants organized lobbies against the elimination of bookkeeping procedures. Expediters, of course, were extremely unhappy with the course of events.

At that stage, the debureaucratization program had become very popular, and we decided that the time had come for bolder action. We had attacked bureaucracy at the federal level and stimulated states and municipalities to do the same at their levels. However, exemption of federal taxes only touched the upper part of the bureaucratic iceberg. State tax on circulation of goods remained a serious hindrance in the life of small companies. The same remains true with respect to social security contributions and excessive requirements imposed in connection with a grant of official loans.

Our original statute of microenterprises contemplated an amendment to the constitution whereby microenterprises or family enterprises, would become municipal entities with no submission whatsoever to federal and state rules. However, it became evident that such an amendment would encounter unsurmountable opposition from federal and state authorities, particularly the tax authorities.

By the end of 1983, time was running short, and my only alternative was to seek a compromise solution consisting of two separate bills. The first was to establish special legal treatment of microenterprises in the areas of taxation, social security, labor obligations and official credit facilities. The other bill was to authorize states to exempt small companies from tax on circulation of goods.

The extensive use of the media and spontaneous popular, political and institutional support converted the statute of microenterprises into a major political and economic issue. The two bills were unanimously approved by the Congress in spite of resistance by virtually all state secretaries of finance.

One of the limitations of a program like this is that we are a federal system. Several provisions of the statute were not dependent on regulatory action of the government at all levels. Yet we felt that the statute would have one political effect: it would break through the rigidity of formalism and bureaucratic resistance.

It should be noted that prior to the debureaucratization program, small companies had virtually no political representation. Today, in most states, there are associations of small enterprises capable of presenting their claims and defending their interests before the government on all three levels and in the Congress as well.

One evidence of the political and cultural impact of the statute is the introduction in the constitution, now being drafted in Brazil, of specific provisions assuring separate legal and administrative treatment to small business enterprises. These provisions would have been unthinkable five years ago.

Of course, the statute is not a finished work of legislative art. On the contrary, it has defects and omissions. It must be perfected and, like any legislation dealing with economics, it is subject to constant alterations. Nevertheless, it stands as a symbol and a landmark of modernization in Brazil.

Over the last two-and-a-half years since the statute has been enacted, 1.5 million new companies were organized or re-applied as microenterprises. This year, in spite of the severe economic problems the country is facing, 250,000 new microenterprises have been created. It's not possible to state how many of these companies have succeeded or survived, but it's a strong indication of the need for differentiated legal treatment of small companies.

One final remark: In Brazil, we clearly elected to reduce the cost of legalization so as to reduce the size of the informal economy. We believe that the benefits of legalization, or formality, should be extended to everybody and thereby keep the size of the informal economy within natural limits.

Luis Eduardo Magalhaes

Mr. Luis Eduardo Magalhaes is a board member of the Chambers of Commerce of Sao Paulo, Brazil, as well as director of two private firms doing business in real estate and farming. He serves on the board of directors of Credit Commercial de France, Banco de Investimento Brazil, the United World College, Sao Paulo Chamber of Commerce and the Brazilian Association of Sales and Marketing executives.

An informal economy exists in all countries and all systems to a greater or lesser extent. It seems, however, that it is most significant in countries where the costs of formalization are higher, whether in bureaucratic or tax terms.

Though many individuals are active in the informal sector by choice, either because they are opposed to any type of control or because of the temporary nature of their activities, there are also a large number of individuals who keep their business informal because they would not be viable if they were to meet all bureaucratic and fiscal obligations. The majority of the latter wish to formalize because informality too has its costs. The greatest of these is the impediment to growth posed by limited access to the banking system and even to many potential clients and suppliers. Vulnerability to the tax man is also an important cost. Evidence of the majority's desire to formalize its businesses in Brazil came from the passing of the microenterprise statute, which, although it cut through only some of the red tape and removed only part of the tax load, led to the formalization of a large number of small businesses.

The data about the labor force reveals the existence of a broad informal economy in Brazil, which some studies estimate to be 12 percent of the gross domestic product. A national home sample poll shows that of an economically active population of 55 million in 1985, a little more than half were informally employed: about 13 million in agriculture and

15 million in the cities.

Formal or partially formal small and microenterprises are a substantial proportion of existing business. Today, 70.6 percent of commercial firms have fewer than five employees; 63.2 percent of industries employ fewer than ten people, and 60.9 percent of the firms in the service sector have fewer than five employees.

In spite of this situation, Brazilian law, as a rule, treated all firms the same. The tax burden and bureaucratic requirements were established on the basis of the situation of the larger firms, and even for them, the requirements have been shown to be excessive. These taxes and rules were applied indiscriminately to small, medium and large enterprises.

The creation in 1979 of the Ministry of Debureaucratization was an important step in the struggle to simplify the lives of business people. At the same time, the Chambers of Commerce of Sao Paulo, together with other business groups, organized small business congresses in order to debate the problems of the small companies. A list of the main obstacles confronted by the smaller firms was drawn from these discussions to direct the action of the business organizations and help the Ministry of Debureaucratization in the struggle for a bill establishing fiscal and bureaucratic requirements for microenterprises and protecting them from the existing legislation. The points raised at these congresses included fiscal, credit, labor and social security problems as well as the ever increasing state interference in the market.

Starting from the diagnosis of small business' main problems, the Ministry of Debureaucratization and the business organizations tried to sensitize other sectors of the government and the national congress to the need to treat smaller businesses differently. The initial idea was to draft a bill to establish minimal fiscal and bureaucratic requirements, making small businesses immune to existing legislation. This ideal solution gave way to the more realistic solution of exempting them from some taxes and some bureaucratic requirements.

The bill was greeted by the business organizations not as a solution to the problems of microenterprises but as a first step in that direction and, beyond that, as a first recognition by the government of the need to treat businesses differently according to their size. In spite of its limitations, the bill produced significant results in quantitative terms, as Dr. Piquet Carneiro mentioned: as much by the regularization of the situation of previously existing small businesses as by the creation or formalization of new firms. The costs of formalizing a firm are still very high and are a factor encouraging informality.

The duties on payment of labor are especially important in inhibiting formalization and employment-generation. This explains in part the existence of a large contingent of unregistered employees. Of three million businesses registered with the social security system, about two million declare they do not have any employees. Comparison of this data with those of the national home sample poll on unregistered workers leads one inevitably to suppose that many firms which declare that they have no employees actually employ people without registering them and that many other firms do not register all of their employees.

Two years after the bill's adoption, the following main criticisms can be listed. The bill did not consolidate microenterprises' obligations but only created some exemptions, requiring small businessmen to track all of the national, state and local legislation. The bill extended the net sales limit requirement to 10,000 OTNs (Obrigacoes do Tesouro Nacional, or National Treasury Bonds), the equivalent of about U.S. $33,000. Thus, only very, very small businesses can benefit from the bill. The inapplicability of the bill to small businesses whose sales surpass the 10,000 OTN limit is a disincentive to growth and complete accounting for sales.

Nevertheless, the microenterprise statute was an important achievement for the entrepreneurial class. This bill established simplified bureaucratic procedures and some fiscal exemptions for small businesses. Lines of credit were created specifically for them. CEBRAE, the Brazilian support system for small and medium-sized firms, along with business associations like ours, has sought to offer advice, help with fiscal and accounting problems, orientation to new techniques and directions for business.

However, the benefits of the small business bill are limited and apply only to the smallest enterprises. The credit lines never have sufficient funds, especially in periods of economic contraction. The loans are of very short term, and there are still problems of lack of guarantees. Unfortunately, efforts by CEBRAE and the business associations are not enough to meet the needs of the bulk of small firms. And if these problems were not enough, small businesses face extra difficulties because of high inflation rates and stabilization programs to which are added frequent changes in economic policy.

In spite of this web of problems, small and microenterprises and the informal sector in Brazil have an important role in the Brazilian economy -- not only by their number and the number of jobs they represent but because of their geographical and sectoral spread.

Starting from this microenterprise statute, more complete legislation could be drafted to favor small businesses, assuring them equality of opportunity and competition through regulations based on their characteristics, possibilities and needs. The draft constitution being debated in the country contains the principle of differentiated treatment for small businesses, which will undoubtedly ease the drafting of a new bill with broader benefits.

The debates on the bill helped to show the politicians and the society as a whole the importance of small business - not only for the economy but also for social stability. It created a consciousness that the market economy, based on small businesses, is the best way to make economic development compatible with political liberty.

Dr. Edward Hudgins

The discussant for the panel was Edward Hudgins, who received his Ph.D. in political theory at American University and his bachelor's from the University of Maryland. He is a fellow at the Heritage Foundation and director of the Center for International Economic Growth.

As Hernando de Soto has noted, we are in a situation today, in terms of economic development, similar to the situation that existed in the late 1700s and the early 1800s. At that time, you had in the United States, in Great Britain and on the continent of Europe a rising class of entrepreneurs, individuals whose wealth was based on their own efforts, on their own hard work and on their own innovation. You had opposing them a privileged elite who held political power based to a large extent on birth and family connections and who held economic power based to a large extent on state monopolies and various mercantilist restrictions.

At that time, the revolutionaries and the reformers were those who opposed the vested interests in the name of the common people, those who promoted economic freedom, understood basically as the rights of private property, and those who promoted political participation and accountability of the rulers to the people. In a sense, when we face Third World development situations today, we're in a very similar situation as we were several hundred years ago. We can make the same arguments and apply the lessons of several hundred years ago, I think, to the situation today.

We have discussed some of the particular economic means by which we go about reform, by which we try to break the system of interest groups. I simply want to focus on two of the aspects that have been brought up here. The first is the importance of rhetoric: that is, the importance of how to advance the debate within a particular country. Rhetoric and debate are important because, first of all, it explains to people the nature of a problem. It educates them in terms of how to change and reform a situation. Perhaps just as important, it inspires people, both the elite as well as the common people, to understand that they don't have to exist in the situation as it is, that poverty is not their necessary and predestined role in life.

I think that a very important function of the rhetoric you use in the discussions in your countries is not only to educate but to inspire people, to show them that their actions can indeed have consequences. The use of rhetoric must be applied to each country individually. In some cases, perhaps the case of Paraguay, you have to be careful about appearing too radical. You have to appear reasonable; you have to be, as it were, a Fabian capitalist, just as you had Fabian socialists in Britain in the last century.

In other countries, again, a more radical approach, where the rhetoric indeed will be stronger might be appropriate. It will be a rhetoric of: "We stand for the rights of the people. We stand for the rights of the poor, the opportunity of the poor to advance. It is the ruling elites, the privileged, who are creating the problems and are keeping people in their poor situation."

Again, the question of how to apply it would depend on each particular country. You have to avoid, for example, misunderstandings of terminology, as Hernando de Soto pointed out. In many countries, "private" in the sense of private enterprise does not mean a free market system: it means privileges; it means businesses existing with government subsidies, with trade protection and so on. So you have to tailor the rhetoric to your country.

But I think in the end you're going to have to appeal to the self-consciousness of the people. You're going to have to show them where their real interests lie. Remember: The Marxists often appeal to envy; that's part of the way they gain power. I think in our rhetoric we have to turn it around and appeal to that other side of human nature that's opposed to envy, and that is pride or self-esteem. We have to say to people, "Look, you can do it too." People in Peru come to the cities from the countryside. They don't have college degrees, yet they make it in the informal sector against all odds.

There is also the need for education. I mean education on two levels -- first of all, of elite groups. And when I say

"elite groups" I don't mean necessarily the people in power. They're probably not going to listen anyway. I mean community leaders, leaders at the local level and students. This is, I think, another very important aspect. You have to keep in touch with your grassroots members. You have to use the media whenever possible to bring out ideas, to at least start a debate. Because if you start talking about the issues, in the end, you will win.

Just in summary, I believe that ideas do have consequences. Economic reforms, as we have discussed, are important and indeed at the basis of the elimination of poverty. But an important part of the battle is going to be the battle for ideas, the battles for the hearts and the minds of the people.

We have succeeded in the United States, in Western Europe and in other countries. I don't see why it has to stop there. I think that this is a revolution that eventually is destined to sweep the world.

PART V

BUILDING GRASSROOTS CONSTITUENCIES FOR ECONOMIC CHANGE: REPLICATION

Moderator:	Juan Bendfeldt, Center for Economic and Social Studies, Guatemala
Tunisia	Moncef Bouchrara, Ideas and Communications
Kenya	Dr. I. Onyango, Ministry of National Planning and Development
South Africa	Japie Moropa, Get Ahead Foundation
Venezuela	Jesus Eduardo Rodriguez, Institute for Liberty and Democracy/Venezuela
Discussant:	Helen Soos, Private Sector Office, African Bureau, U.S. Agency for International Development

The panel had the task of assessing the potential for replication of the Latin American advocacy programs in other countries. The panel was moderated by Dr. Juan Fernando Bendfeldt, director of the Center for Economic and Social Studies in Guatemala, professor of economics and ethics at the Francisco Marroquin University and director of studies at the Guatemala Development Foundation. He is a member of the board of Francisco Marroquin University and the Guatemala Development Foundation. Dr. Bendfeldt is the author of numerous publications and is a columnist whose byline appears regularly in Prensa Libre.

Juan Fernando Bendfeldt

I have asked the panelists this morning to respond to the following question: Is the informal economy strictly a Latin American phenomenon, or does it have pretty much a universal character, wherever certain conditions seem to appear?

I will add only one example of my experience in the informal sector of Guatemala. Guatemala City has a population of close to two million and anyone who lives in a big city can probably imagine the amount of trash and refuse that accumulates from day-to-day.

Well, Guatemala City is quite a peculiar case. The entire trash collection system of Guatemala City is informal. Most of the vehicles used are privately-owned, discarded old vehicles that cannot meet the traffic regulations. The owner of the vehicle usually drives it, and you see two or three workers hanging on the trucks that go to each house, for a very low cost, every day to pick up the trash.

These workers receive no salary. They have only, as remuneration for their work, the right to sort through the garbage once they get to the city dump. By all our estimates, they make more money this way than by receiving minimum wage. As a result, we have perhaps the most efficient system of recycling trash very inexpensively. The trash is classified and then reintroduced into the formal economy.

The trash collection system is the major supplier of the paper industry in Guatemala. It makes cartons and other industrial types of paper, plastics and glass for glass containers. So, in general, you see it is not just the little guys but a very complex network: a complete spontaneous order, very sophisticated, very efficient.

It is not anarchic, but it is not due to the Office of City Planning Bureau that this system is working so efficiently. This is basically, a free, unhampered market. With that in mind, perhaps our basic policy objective should be to advance proposals that tend to go in that direction -- the liberation of the market -- and in no other direction.

Moncef Bouchrara

Moncef Bouchrara is a civil engineer by profession, with degrees from the University of Paris. He formed his own consulting firm in 1977 and is also founder and president of another company, Ideas and Communications, established in 1987. He has taught for the last ten years in the School of Engineers of Tunis and now teaches in the School of Architecture as well. He has organized numerous seminars on the informal sector and this year held the first trade fair on indigenous innovation and a symposium on "The Informal Sector, Rampant Industrialization and Diffuse Economy."

Ladies and gentlemen, it is my pleasure to address you today not only as a Tunisian but also as an entrepreneur.

Tunisia is a North African nation of eight million inhabitants and was a French colony until 1956. Tunisia has gone through three stages. The first stage, until the beginning of the 1960s was the building of the state. Second, the socialist experience lasted through the 1960's and has now been popularly rejected. The third stage was the so-called liberal policy of the 1970s.

During the 1970s, the state led an ambitious policy of industrialization, heavily subsidized with, let's say, a very Western point of view of how it should be implemented. As we discover, today, that type of industrialization suffers, especially within the public sector, from inefficiency, over-investment and high rigidity.

But over the years, an informal vigorous Tunisian sector grew in competition, but also in cooperation, with official industry. Part of this informal sector arose as a second, hidden industrialization. It has a great ability to develop systems of production, with little capital, but with wonderful, enormous ingenuity. The reality is that the informal sector represents an integrated economic structure with enough internal rationality to have significant control of the development process of my country.

I probably would facilitate the discussion if I give you an example of the dimension of the informal sector. I am going to release a state secret: Tunisia is probably beating the world record in building houses per capita and per year. The government is very proud to announce that Tunisia every year is producing 40,000 modern dwellings with modern building materials, and that is a very respectable figure for developing countries. It represents five dwellings per year per 1,000 inhabitants.

In fact, the figures show that it is probably 80,000 dwellings per year. This figure is a world record. In fact, this point is astonishing because only 20 percent to 25 percent of production is by big companies, especially state companies. Seventy-five percent is due to the diffuse economy in domestic construction. Tunisia is not an urban anarchy; these dwellings are viable and constitute an accumulation of capital on a large demographic basis enabling families, in ten years, to finance

the son who wants to set up his own microenterprise.

Let me tell you about the brick industry that I have studied closely. In 1972, Tunisia produced 300,000 tons of bricks, three-fourths by two state companies and a quarter of it in the informal sector. Twelve or 13 years later, this production has been multiplied by ten. The state companies represent only 15 percent of production; the private industrial companies represent 60 percent, using imported technology and subsidized investment. What is most surprising is that a quarter of the market is within the hands of the informal sector, 150 small entrepreneurs all around the country.

Another example is the shoe-making industry. Tunisia, we believe, is producing 20 million pairs of shoes. Half are produced by the informal sector and sold on the market with fierce competition from heavily subsidized industry.

Mr. Bendfeldt, for example, had been speaking about what we would call the trash economy in Guatemala. What is interesting to know is that the trash economy, which probably exists in all of our countries, is not a dispersed economy, even if it is diffuse. You discover, if you take the time to look, a very dense network.

We are here to identify practical tactics to promote that large target group of popular entrepreneurship. I personally, as a modest private actor, have identified at least three ways: First, is the work that de Soto has done so well in his country by identifying the legal barriers that forbid a small producer to enter a sector.

The second way is changing the image of indigenous entrepreneurship in our countries through a strategy which I would call a capillary communication action: pushing journalists to speak about vivid examples, creating new heroes. If you go to any of our countries, ask for the newspapers: the first pages are on political matters, and the three last pages are about sports; one page is about singers. When you have that type of structural information and you ask your son, "What would you like to become?", he answers immediately, "I want to become a minister or a soccer champion."

The third way to promote the informal sector, I believe, is to find a global explanation of the bias between the regulations and rules and the reality of popular entrepreneurship in our countries.

Our regulations come from the colonial period. At that time, the view of the Muslim or of indigenous people was that they couldn't be considered as a source of economic wealth. The indigenous societies by themselves were not considered as a source of industrialization, economic growth or technical change. I believe that is why we have to explain that our societies, our people, as they are, whether illiterate or not, are wonderful entrepreneurs.

Dr. I. Onyango

Dr. I. Onyango has a Ph.D. in labor economics. He is the principal economist at the Ministry of Planning and National Development in the Republic of Kenya. He is the head of the informal sector unit at the Ministry of Planning and a member of the Task Force on the Informal Sector in the Republic of Kenya. He is a former research fellow in the Department of Business Studies at the University of Edinburgh.

Ladies and gentlemen, it is my pleasure to present my paper on the informal sector in Kenya. In my presentation, I am going to talk about policy issues, strategies and the constraints. I will try to answer three questions: first, why are we, in the government in Kenya, interested in this very important sector; second, what are we doing to mobilize the resources of the informal sector; and finally, what are the constraints?

Kenya's population today is about 22 million people. In the year 2000, which is about 13 years away, this is projected to rise to about 35 million people. This will be 78 percent more than we had in 1984. Of these 22 million people, 14 million will comprise members of the work force, and nine million people — that is about 25 percent — will be living in urban areas.

Three basic issues arise from this phenomenon: first, what are these people going to eat; second, where are they going to work; and third, where are they going to get shelter? In addressing these three issues, the Kenyan government has published a policy document that is going to guide our development planning to the year 2000. The document has seven chapters, and we have devoted a whole chapter to the informal sector.

In this development strategy, agriculture continues to remain the mainstay of the Kenyan economy. To stimulate agricultural production, small-scale, agro-based industries -- basically in the informal sector -- should be promoted close to the rural areas where 80 percent of the Kenyan population lives. The growth of these enterprises is considered important because they produce the basic inputs required by small-scale farmers: farm tools, machinery equipment, chemicals, services. Increased farm incomes will increase other demands for

small-scale products and, thereby, stimulate their growth. The informal sector enterprises, located in the rural areas, also provide employment opportunities for the rural population.

The informal sector enterprises are also important in another respect. We have to create employment opportunities for ten million people ten years from now. The formal sector requires some $20,000 to create one job. That is a lot of money, given the resources at the disposal of the Kenyan government. However, the corresponding job created in the informal sector costs less than $5,000. This suggests that if we have to make an impact in terms of employment creation, more attention should be put on the informal sector.

Our average rate of investment today is about 25 percent of gross domestic product, which is a reasonably high level by any standards. If we maintain this level to the year 2000, we shall only be able to create 1.4 million jobs. If we add those to the 1.5 million that we have at the moment in the formal sector, the economy will have only three million jobs for a labor pool of 14 million. Where is the surplus -- that is, 11 million -- going to be employed? To accommodate these people requires the creation of 900,000 jobs per year from 1984 to the year 2000. If we have to make an impact on employment for the labor pool, resources have to be invested in the informal sector.

It is estimated that the informal sector in Kenya today employs about 40 percent of the work force in the urban areas. Sixty percent of shelter in the urban areas is generated by the informal sector, and up to 80 percent of transportation in the urban areas is in the informal sector. With these considerations, we are persuaded that the informal sector is a key factor in development to the year 2000.

Between November 1985 and June of last year, we held a series of six national conferences, discussing the subject of the informal sector. The idea was to create an awareness within the government, among scholars and within the business community on government intentions about mobilizing this sector. During these conferences, it was made clear by the government that the informal sector is no longer a collection of illegal activities.

Further, in last year's policy paper, the government said it was going to establish a special unit on the informal sector whose duties were to coordinate all activities related to the informal sector in order to ensure that they receive their due emphasis in development planning. This unit was formed in March of this year, and I am attending this conference as head of that unit.

In the same documents, the government said it was going to establish a special task force charged with the responsibility of reviewing all policies, particularly local authority and municipal authorities' bylaws that tend to impede the operation of this sector. This special task force was formed in April of this year; the report is ready and could be submitted to government any time now. The task force had the responsibility of going through all the policies, quite a number of which have been rather prohibitive to the smooth operation of the informal sector.

This financial year, '87 through '88, the government has provided an allocation of U.S. $12.5 million for construction of infrastructure facilities to assist the informal sector, particularly in designated small towns in the rural areas. In a few places, some of this infrastructure, in the form of sheds, has been completed. The idea is for the sheds to have water and electricity to mobilize this sector.

Tax incentives are being offered today. If the informal sector operator opens a business in the rural areas, he is exempted from duty to the tune of 60 percent of his gross profit. If he imports raw material from outside, most will be duty-free.

The government, in collaboration with aid donors and the Kenya Commercial Bank, is operating an informal sector pilot scheme. The idea is to provide lessons on how to give credit facilities, without necessarily requiring collateral security.

The Ministry of Industry is compiling a booklet aimed at educating the public, particularly the informal sector operators, on assistance programs that are available from government and how they can benefit.

Let me conclude by briefly talking about some of the constraints that we are facing. The data base is very weak. Some work has been done on the informal sector, but it is mainly based on urban areas. Most of these studies are uncoordinated, and my Informal Sector Unit is, at the moment, trying to take an inventory of what has been done to identify gaps for further research.

Further, most informal sector artisans are very skilled people. Although they have very useful skills, they are lacking in complementary commercial skills. You will find that most of these businesses do not last more than five years. Although they have the artisan skills, they are deficient in commercial skills such as business management, marketing and accounting. Measures are being taken now, in collaboration with donor institutions, to impart some of these skills to make these artisans more versatile in the market.

Finally, marketing seems to be another problem area. Most of our programs seem to emphasize the supply side. But we are saying, "What can be done after these people produce?" Last Sunday, my colleagues in the Kenyan delegation and I had the privilege of having dinner with the Friends of Kenya organization here in Washington. When we went there, what did we find? The informal products are selling in the streets of Washington: that is how dynamic the informal sector is in Kenya's economy.

I would like to conclude by saying that the government of Kenya recognizes the great potential that is inherent in this sector and, currently every effort is being made to mobilize and exploit this potential. The major constraint, as I see it, is that of financial resources, but the will is there; the push is there, and we are convinced that we are moving in the right direction

Japie Moropa

Mr. Moropa is deputy managing director of the Get Ahead Foundation in South Africa. He has degrees in personnel management from the University of South Africa and in community development and financial management. Before joining the foundation, Mr. Moropa was a training officer at the Corporation for Economic Development and taught accounting. He is also a member of the Match Maker Fair Committee of the American Chamber of Commerce in South Africa and on the Advisory Committee of Small Business of Reverend Leon Sullivan's signatory companies in South Africa.

Briefly, our company, the Get Ahead Foundation, is a black-owned and directed company. Our chairman is Dr. Motlana, who is also chairman of the Soweto Civic Association. Other board members include Archbishop Desmond Tutu.

Our objectives are to develop the communal and business interests of blacks in South Africa. We do so in a number of ways. First, since we have a very high unemployment rate in our country, we have started a micro-loan scheme where we will lend up to $150 to enable people to get started in business in the informal sector. Second, we have a larger lending scheme of up to $5,000 to help people become backyard operators or informal sector entrepreneurs. Third, we have a very active mentoring or counselling program with international executives who have now come to South Africa. Finally, we organize seminars on marketing, bookkeeping and trade skills essential to our disadvantaged people.

We have been recognized as being the only organization in the country that is totally immersed in informal sector development. We have also been described as being the most effective community-based organization. We are, in fact, a grass roots organization. However, everything that we do is illegal because we are developing the informal sector. This means that we have to break laws, regulations, bureaucratic practices and business rules as well as apartheid laws.

Let me describe the case of a street vendor selling fruit or vegetables or shoe laces. She is the sole breadwinner for her family. Whatever she can earn through this small business is used to buy food and to provide shelter and school books or fees for her own children.

However, the law says that if she does obtain a license, she must act decorously. She may be illiterate or semiliterate, and yet, she is presented with a 23-page document that lists the street vendors' regulations. If she sells newspapers, she must then stand one yard in front of the street corner and occupy a certain area. Her newspaper stack may only be of a certain height. If she is a mobile vendor, the regulations say that she must sell her goods at one place for one hour. At the expiration of the hour, she is then obliged to move on to another area 100 yards away. There she may trade for one hour, but when that hour elapses, she is then obliged to move on to yet another area which is, again, 100 yards away but is not the same as any area previously occupied by her for that day. If she is found by the authorities to be in breach of either the time factor or the distance factor, she is then officially prosecuted. A summons against her is issued.

By the way, in the course of our discussions over the last few days, one has heard references to informal markets or trading markets. In South Africa, our laws and regulations do not permit this to happen. Yet we at Get Ahead have started building these unofficially or illegally. Perhaps the best illustration is that of Cross Roads in the Cape area. We built an informal market for the people there which has blossomed to the extent that it is now the central business district in that area. Thus, economic change has been brought about by a bold step.

The laws of the country are such that we are totally overlegislated. These laws and practices prohibit economic development and change. Two years ago, the parliament passed the state president's Deregulatory Act that authorized the state president to suspend any law or regulation which prohibited economic development. To date, no law or regulation has been suspended.

There are many laws which militate against a black business person. These are specifically aimed at keeping the

black people out of the economy. Let me give you some examples. First, the Community Development Act, Section 43, states that no license to trade in a white area shall be given to a black person. Thus, by law, licenses to do business are prohibited. I am happy to tell you that we are starting to overcome this by arranging for whites to acts as nominees.

Second, our Group Areas Act specifically prohibits black people from owning or renting property in areas of their choice. Thus, they are denied geographical mobility and ability to choose location.

Third, the Land Act of 1913 denies us the right to hold direct title. Our organization, Get Ahead, has become widely known in South Africa for its willingness to act as a nominee or front for any black person who wants to occupy a business or dwelling house in a white area. We have fronted for hair salons, fast food outlets, craft shops and others. The attitude of our board is that people should not be denied access to the economy purely because of the color of their skin. Thus, by giving a lead to the people, we are bringing about a practical change.

Apart from these regulations and laws, bureaucrats are also given immense powers. Thus, they may swoop on our lady vendor and, by law, confiscate the goods and destroy them immediately. However, there is mounting opposition to this, and a classic case recently was that of two shoeshine boys removed by the security people from the front of the stock exchange building in Johannesburg. Fortunately, the press and members of the stock exchange protested so much that they have been reinstated, despite the fact that they trade illegally. Thus, the informal sector has been able to bring about a certain amount of economic change.

There is no doubt that our business world is totally rigid and unsupportive of the informal sector operators. Merely as an illustration, our banks and First World lending institutions require collateral in the form of property ownership or two years trading figures for a loan. Our disadvantaged people are not able to own property, and, more often than not, they have not been able to trade and, hence, be in a position to produce two years of trading figures.

However, change is occurring. In the transport sector, for instance, we have observed a considerable blossoming of the informal operators. Many may be licensed, but recognition is now being given to a great percentage which are not licensed and are purely informal operators. For the first time, they are able to obtain credit merely to carry on business.

Further, a well-known building society which lends money to home builders has changed its policy towards the informal sector. Our black people are bound by law to live in townships like Soweto. These townships are very crowded: ten people or more living in a small four-room house, the matchbox house. To meet the housing demand, people are building garages for occupancy at a rent at $50 per month. The building society has recognized this trend and grants loans for these buildings.

What saddens us in our country is that we hear of other countries speaking of 60 percent of the work force being employed in the informal sector or that the underground economy accounts for 60 percent to 80 percent of the GDP. Tragically, this is not yet the case in our country. One of our financial journals said that our informal sector accounts for only 5 percent of the GDP. What a lovely challenge for the future to Get Ahead! Can you imagine us trying to catch up with the rest of you seen in this hall today?

However, from the black political point of view, you should also be aware that our leaders are starting to say that the flip side to political power is economic power. Our own chairman, Dr. Motlana, is encouraging people to become involved in earning money. He urges them to get into the informal sector. He is saying that in a post-apartheid society, our people must want to earn money, instead of begging for it. He is, thus, suggesting a system based on free enterprise — we do not use the word "capitalism" because this is equated with apartheid in South Africa. Rather, we use the expression "free enterprise" because it carries with it the connotation that the economy will be freed and our disadvantaged people put in a position of being able to participate freely and enjoy the benefits of their labors.

Jesus Eduardo Rodriguez

Jesus Eduardo Rodriguez is a member of the board of directors of the Caracas Chamber of Commerce in Venezuela. Mr Rodriguez is also founder and vice president of Cedice, founder and director of the Institute for Liberty and Democracy, Venezuela, and director of several business organizations. He received his university degrees from the University of Michigan and Stanford. His most recent publications include a measurement of the Venezuelan informal sector.

I would like to begin by mapping out some of the thoughts or concepts that have been mentioned during these last two days. What I am going to say today is the result of five years of work done in Venezuela with the help of more than 100 entrepreneurs, people from all levels of the private sector in

Venezuela.

In Venezuela, more than 47 percent of the work force is employed by the informal sector. We have found that more than 32 percent of the non-oil GNP is produced by these informal entrepreneurs.

Informality has been seen as a revolution. I would say that the informal revolution is simply the answer to the control of our societies by people who base their actions on an ideology or culture of the left. This collectivist ideology has eliminated legal, political and economic institutions which promote development and guarantee the basic human rights of life, liberty and property. The absence of social structures which promote the human being as the center of the society is the basic cause of the underdevelopment of Latin American countries and most countries in the world.

The political sector has gradually created a public administration of tremendous magnitude. In Venezuela, by 1984, there existed more than 500 state-owned corporations in all economic sectors. In the early 1960s, the state-owned corporations absorbed 25 percent of the consolidated public budget; by the beginning of the 1980s this proportion had grown to more than 75 percent.

These corporations have become huge populist and clientist mechanisms for the political parties and other organized sectors who obtain enormous resources from the state. They have served, instead, to increase the antagonism between capital and labor and have not promoted the complementarity that should exist between the private and public sectors. The intervention of the state has gradually reduced the size of the civil society and increased the participation of the political sector in all aspects of social life. This progressive statization has diminished formal private initiative and has generated more bureaucracy, inefficiency and corruption.

In the legislative area, the influence of this leftist ideology is even more pervasive. Laws are generated by the executive branch and not from the legislative, contravening the constitutional order and destroying the economy. In Venezuela, these decrees and laws have increased bureaucracy from 300,000 public servants in 1972 to more than 1.5 million in 1984. The economy is managed by these employees of the executive branch who determine, for example, who can invest, who is granted a license to import goods, who benefits from subsidies or exonerations. Under this climate of legal insecurity, there exists a lack of faith for new investments and, hence, for creation of new jobs.

The human being, who is basically ingenious, has found a way to survive. Based on fundamental ethical values and following the common law, he has developed what we call today the informal sector, which is a sort of primitive capitalism and, at the same time, the genesis of individual initiative.

There are many solutions. In the case of Venezuela, we think that there are three main points. First, in the political system we have to increase the amount and level of political information available to the common citizen.

We have to promote personal initiative, as opposed to state paternalism, and we have to foster motivation for achievement. The same political order will have to balance the judicial sector with the executive one, taking the political parties out of the judicial sector to make the administration of justice more efficient. We have to rescue the judicial system so that the civil society may demand its rights from the public sector.

In the economic order, we think that it is very important to promote private initiative as a natural and efficient job generator. We have to educate the average citizen on his rights and duties so that his products improve in quality and so that he will be able to defend his rights. We have to search for means to increase the productivity of microenterprises. We have to fight for the removal of limitations imposed on productive entrepreneurial activities that remove privileges. We have to fight for real and fair competition between producers so that anyone may enter and remain within a specific market.

Within the social order, we think that it is important to promote active participation of all members of society: consumers and producers. Something else that we have found important in Venezuela is the fight against conformism.

As a final word, let the informals work in their sane environment. Do not contaminate them with our overregulated world and try to approach them to develop a better society. Thank you.

Helen Soos

The discussant for the panel was Ms. Helen Soos. She graduated from Radford College with honors in international relations and obtained a Master of Arts in international economic development from the Fletcher School of Law and Diplomacy. Ms. Soos has been with AID for 12 years. She has most recently served as director of African Affairs with the National Security Council in the White House. She has spent over ten years in Bolivia, Central America and East and West Africa and has worked in more than 30 developing countries.

The turnout at this conference reflects the extraordinary response that people are feeling to these ideas. In my Peace Corps days in West Africa, I often heard the term "je suis petit capitaliste," "I am a petty capitalist;" people were very proud of their entrepreneurial spirit. In fact, trading has been part of the history of Africa for thousands of years reflecting the human entrepreneurial spirit. It is important to promote this petty capitalism, this informal sector, because it is one of the few sources of growth in these economies. This growth occurs at the grassroots level where it is most needed to meet a great variety of basic goods and services.

Another reason for the response to this conference is the inherent distress and antipathy for bureaucratic society which seems to be sweeping the world. Max Weber was correct in his analysis that bureaucracies have an inherent tendency to perpetuate themselves. They perpetuate power by creating new rules. They have the capacity to mushroom into structures and processes that no rational human being would ever create or condone. For a bureaucracy, rules and red tape become an avenue to power and an opportunity for corruption.

Now, I would like to propose three steps to build constituencies for broad-based economic participation that will help resolve the issues of poverty in the Third World. First is consciousness-building: understanding and creating an awareness of these issues. The research that has been done in Peru is not only an inspiration to all of us, but represents a very significant step in encouraging the kind of dialogue that we have had here.

A second step in building a constituency is to promote and expand policy dialogue into these areas. While some areas of policy issues which affect grassroots development have largely been ignored by the donors and by many governments, there are some which, at least technically, should be palatable for discussion. Property laws, the ability to acquire and defend property, should be entered into the spectrum of policy dialogue, as should tort laws which help to control the private sector. However, as long as the private sector consists mostly of the political elite or has close alignments, it may be difficult to introduce tort laws.

In the foreign investment sphere, we have recognized that bureaucracy is onerous, and in some countries, such as Mauritius, one-stop investment centers have been created. Each of the six, seven, eight or 20 government agencies whose approval is needed for an investment in that country have offices in one central location, and a businessman can go and simply find out what the regulations are and meet them. This approach could be tried in the informal sector.

The third step is to promote economic pluralism without which there can be no constituency for challenging state power. State economic power must be challenged because it is inequitable and inefficient to a great degree. The preeminent role of the state must be counterbalanced to create the basis for compromise and to avoid abuse. There are many options for building economic pluralism. We have discussed the informal sector, but there are other options. Agricultural cooperatives, if left alone by governments, can create economies of scale for marketing or input supply. Another example is credit unions which can compete with banking sectors that simply don't reach the poor.

Finally, one last approach, which I consider to be an ideal in its impact on the informal sector is privatization. There is a desperate need to privatize state enterprises. However, it is always hard to find a good buyer. Private buyers are often foreign investors who, politically, are not acceptable, or the local economic elite might invest, which is sometimes equivalent to crony capitalism. Neither of these options is very appealing. The alternative that I propose here is called "The Employees Stock Ownership Plan." In terms of efficiency, it has proven to be rather remarkable.

For example, the La Perla coffee plantation in northern Guatemala was besieged by communist guerrillas who killed the owner. The owner's son discussed with the peasants how they could defend the plantation. The peasants agreed to give up a part of their salary to purchase weapons in return for a share of the stock. Production has increased by 300 percent. Recently, the Economic Commission for Latin America adopted a resolution which was unanimously approved for Latin America, including Nicaragua and Cuba, to explore employee stock ownership as a road to privatization.

I would like to close with the thought that it is important to continue to stress the connection that exists between economic and political stability. The ultimate defense of democracy is a stable political and economic system that can meet the basic economic and political needs of all the people. Economic and social justice, reflected in broad-based ownership and participation is the best and perhaps the only viable long-term recipe for peace and prosperity.

Discussion

Given the role of the Kenyan government in promoting the informal sector, Dr. Onyango was asked to describe the factors leading the government to take this initiative.

Dr. Onyango indicated that the emergence of the informal sector is a response to the failure of the formal sector to satisfy the needs of the population. The formal sector in Kenya is characterized by gross capacity underutilization because of high dependency on oil, high capital requirements and the need for skilled labor. Conversely, he noted that the informal sector uses local resources and has an advantage over the formal sector because it relies heavily on unskilled labor, which is an abundant resource. Dr. Onyango noted that, due to the rapid population growth rates and the need to create jobs, the government turned to the informal sector because it seems to respond better than the formal sector in the areas listed above.

Mr. Bouchrara was asked, "How does the Tunisian government deal with microentrepreneurs who do not operate in the formal sector of the economy? What do they do to the illegals that are caught?"

Mr. Bouchrara indicated that in Tunisia there is a political tradition of pragmatism. Because of the closeness of the social ties, there is always a way of ignoring things and, when it becomes massive, of recognizing it very opportunistically. He also noted that in the last part of the year, the government had taken steps to recognize the informal sector simply because of the need to sustain economic growth.

All members of the panel were asked to respond to the following: "Is there a role that municipal governments, mayors, can play in trying to resolve this informal economy problem?"

Dr. Onyango responded by noting that they have a role in the sense that most of the local laws in Kenya seem to be in conflict with the current government policy of support for the informal sector. He noted that the government is trying to resolve these through a task force that is identifying what sort of reforms should be made. Dr. Onyango, however, felt that the informal sector is a fairly difficult group of people to deal with. They have developed their own system, and it may take time before a government like Kenya's really gains enough experience to deal with this group. For example, street vending in Nairobi is prohibited, according to the existing laws. One way the government has tried to deal with this is to create markets, but most often the informals move out. As far as the informals are concerned, Dr. Onyango concluded, the market is better if they can sell in front of, say, government departments.

In South Africa, Mr. Moropa explained, the Get Ahead Foundation helped vendors to form organizations to approach the municipalities to try to avoid harassment and to convince the white municipalities to build informal markets. Instead of leaving these vendors to sell in the open, the informal markets give a sense of commitment. Because they have an association, he noted, they will clean that informal market and keep it very tidy, and the municipalities are responding very well to the idea.

Based on his experience in Guatemala City, Mr. Bendfeldt noted that there are about 21 official municipality-owned and sponsored markets throughout the city. But, in effect, none have been built in the last 25 years. As a result, as the city has grown, about 200 underground markets have appeared. Mr. Bendfeldt explained that the markets are a municipal monopoly leading to a situation where regulations, on one hand, prevent the formal sector from working but, on the other hand, do not provide municipal services.

Mr. Bendfeldt also provided an example of market liberalization on the municipal level. He noted that ten or fifteen years ago, the bus companies went on strike. While these buses were privately-owned, they were also overregulated, tax- exempt, and subsidized. The mayors' solution was to go on television and radio and tell everyone to start their own public transportation. All limitations were removed, and overnight there were trucks, school buses and private taxis taking the place of the bus system. Bendfeldt went on to explain that, after the bus strike failed, the mayors asked all the informals to go back home but they didn't. As a result, about 60 percent of the public transportation is provided by informals.

PART VI

EPILOGUE

The first International Conference on the Informal Sector demonstrated beyond doubt that the informal sector can be a source of fundamental political and economic change within Latin America. To a lesser extent, the conference also demonstrated that the informal sector phenomena is widespread throughout the Third World. However, the causes and implications of this phenomena will need to be explored systematically on a country-by-country basis in other regions to verify this finding.

Given the magnitude of the developing world's economic problems, there is a tremendous need to tap the entrepreneurial energy of the informal sector. The Third World debt crisis will continue to be a major constraint on economic growth in many countries in Latin America, Asia and, especially, Africa. According to the World Bank, many debtor countries are now experiencing a net outflow of funds and significant declines in per capita GDP. Under these conditions, countries must liberalize their economies in order to create new sources of economic growth. As Robert Litan noted in his comments, significant productivity gains and economic growth can be attained by removing the red tape barriers and deregulating the formal economy.

Over the next few years, the informal sector concept must move from the research to the implementation stage. The two panels on Building Grassroots Constituencies for Economic Change described a variety of advocacy programs and governmental efforts to attain these ends. However, much more needs to be done.

Speakers at the conference described a variety of policy and programmatic prescriptions to liberate the entrepreneurial energy of the informal sector. The following menu provides a summary of various proposals as a guide for development of action programs.[3] Every country is different, of course, so the mix of policies and programs will have to be adapted to the individual country situations. Nevertheless, the following menu can act as a guide to decision-makers as they contemplate what steps to take.

Menu of Informal Sector Policy and Program Prescriptions

I. Deregulation

(A) Lower the barriers that discourage or prevent citizens from joining the formal private sector:

* Eliminate many current licensing and titling procedures, and consolidate necessary requirements into a single procedure that can be completed in a single (one-stop) office.

(B) Reduce the unnecessary regulatory costs in the formal sector:

* Require all new regulations to pass a cost/benefit test.
* Require public hearings on all proposed regulations, with adequate time for comment and review.
* Establish an ombudsman system to eliminate inefficient and burdensome regulations. (For examples of private and public systems, see presentations by H. de Soto and Dr. I. Onyango.)

II. Tax Reform

Simplify the reporting system for small firms, and provide exemptions for microentrepreneurs:

* Eliminate record-keeping requirements, and provide tax exemptions for certain categories of microenterprises. (Brazil sets a ceiling of U.S. $3,000 in annual gross income, but the level needs to be set depending upon conditions in each country.)
* Collect taxes from informal sector enterprises throughan annual assessment similar to a property tax (the assessment could be challenged by the entrepreneur if it is felt to be too high); this eliminates record-keeping burdens.

III. Access to Credit

Facilitate the flow of credit toward the most productive sectors of the economy.

* Deregulate interest rates to increase savings and channel loans to informal firms already paying much higher rates.
* Privatize the banking system (in many countries this is partially or totally controlled by government).
* Support informal sector lending programs similar to those run by the Get Ahead Foundation of South Africa and the Paraguayan Foundation for Cooperation and Development.

IV. Economic Efficiency

Improve economic efficiency to encourage repatriation of flight capital, remove disincentives for productive investment and remove causes of dual economies in the Argentine model. (See M. Victorica's analysis).

* Eliminate foreign exchange controls, especially the use of dual or multiple exchange rate systems.
* Allow market-type mechanisms to allocate access to foreign exchange.
* Phase out and eliminate price controls.
* Reform the legal system to provide access to justice for informal and poor microentrepreneurs.
* Introduce and/or strengthen laws prohibiting conflicts of interest.
* Enact freedom of information laws requiring full public disclosure of legislative and executive branch decisions.

V. Education and Training

Improved education and training programs for informal entrepreneurs can help to improve business performance when coupled with policy reforms removing barriers and disincentives facing the informal sector:

* Provide training and technical assistance through private and public agencies for existing informal entrepreneurs, including assistance to associations of informal entrepreneurs and support for national development foundations.
* The private sector should encourage economic and entrepreneurial education as part of basic education programs.[4]

VI. Link the Formal and Informal Sectors

Organizations made up of informal sector entrepreneurs have emerged spontaneously in most countries as a result of the common need for defense against the government and, often, the private formal sector. Groups such as the Peruvian Young Towns Association, the numerous street vendor organizations, and others need to be assisted by and linked into the private sector organizations, to foster overall economic growth:

* Provide legal recognition for informal sector organizations.

* Create forums for the formal and informal sectors to work out their differences and formulate joint policy proposals. (See below for a description of a new initiative taken in Peru).

* National development foundations and other groups assisting microenterprises should begin offering assistance to associations representing the informals and linking the formal and informal sectors. (See work done by the Paraguayan Foundation for Cooperation and Development, described by M. Burt.).

The above menu of policy and program prescriptions is directed toward decision-makers in the private and public sectors in the developing world. However, extending the concepts put forth by Robert Litan in his presentation, foreign assistance agencies and multilateral organizations should compare their efforts with the menu of choices to see whether such programs are providing the kind of assistance needed by the informal sector.

Recently, the Institute for Liberty and Democracy (ILD) of Peru developed a program that has the potential to integrate many of the policy and program prescriptions in the above menu. On February 14, 1988, the ILD announced the formation of the "Union Formal-Informal." A number of directors of the National Confederation of Private Business Organizations, the leading business association in Peru, joined with ILD to form the union. The following passage from ILD's announcement in El Comercio states the union's purposes:

"Therefore, we who make up this union are aware that the bold line bisecting Peruvian society is not the horizontal one dividing the entrepreneurs from the workers, where those above make themselves rich with the excess value earned from the poorly paid work of those below. No, for us the true dividing line in Peruvian society is, rather, a vertical frontier to the right of which one finds those politicians, bureaucrats and businessmen who profit and live off the state's favor, and to the left of which we, formal and informal producers, are located, with all our desire to produce, compete and progress in a market open to all. For this reason, we demand the elimination of that legal and political wall protecting some but not others. We want to make the transition from a conservative system that is impoverishing us all to a modern and prosperous democracy."

The union's purposes are to formalize and enhance the ILD's basic work as described by Hernando de Soto in his two presentations during the conference. As was further described in the ILD's announcement in El Comercio, the union has the following functions:

1. The elaboration of concrete proposals to carry out changes in the legal institutions of the country, to ensure that they function to benefit all citizens and, thus, to enlarge the present, narrow frontiers of formality.

2. To promote a system of voluntary work to provide legal advice to producers requiring it and to process and orient their requests.

3. To promote and defend economic rights through the reception of initiatives and complaints from formals and informals.

4. To design and develop projects in the social interest.

The challenge of the next decade will be to utilize private sector organizations, such as the Union, to mobilize the peoples of the developing world on behalf of change. While governmental efforts like those described by Dr. Piquet Carneiro in Brazil and Dr. Onyango in Kenya will play a vital role, the private sectors must awaken. It is the private sector that must form the constituency for change, and it is the private sector that must create the wealth so desperately needed in the developing world.

Transaction costs are those costs resulting from efforts to negotiate and implement agreements required for the exchange of goods and services and to combine the human and material resources needed to produce them. These costs include, but are not limited to, contracts, formation of businesses through law, permits, licenses and other legal instruments needed to do business.

2 Everyone's balcony (El Balcon de Todos) - this is in distinction to the president's balcony, from which decrees and official statements are often made to the public.

3 Portions of the policy menu are drawn from "Internal Structural Reforms in Peru: A Promising Road Out of the Debt Crisis" by Robert Litan, Luis Morales-Bayro and Jorge Fernandez-Baca in the Journal of Economic Growth Vol. 1, No. 2, (1986). The Journal is published by the National Chamber Foundation under a grant from CIPE and is available from the CIPE offices. The menu also draws upon an earlier review of the informal sector conducted for CIPE by ACCION International. The review was put out in a 1986 video report entitled "The Message of the Informal Sector" in Spanish and English. Copies of the video are available on a free loan basis from CIPE or on a rental purchase basis from ACCION International, 1385 Cambridge Street, Cambridge, Massachusetts, 02139, USA (617) 492-4930. Video cassettes are $18 rental, $35 purchase.

4 For example, COPARMEX, the Mexican Employers' Federation, has run a program called EMPRESA with the public vocational education system for the last several years. They have educated 60,000 students in the basics of business and economics at a cost of $2.00 per student. Out of the 60,000 high school students, 2,000 have already gone on to start firms. Similar programs are underway in Argentina, Colombia, El Salvador, Panama and Uruguay, with a new venture being developed in Thailand. All of these programs are partially or totally supported by CIPE.

- SECTION 8 -

EXCERPTS FROM THE "JOURNAL OF WORLD DEVELOPMENT"

The Role of Institutions in Economic Development

Edited by

IRMA ADELMAN AND ERIK THORBECKE

able

-fee
hoto-
opy-
he
ting
per-
ght
py per
Inc.

does
tion.
rmis-
ig.

hard
non

PERGAMON PRESS

OXFORD · NEW YORK · BEIJING · FRANKFURT · SÃO PAULO · SYDNEY · TOKYO · TORONTO

World Development, Vol. 17, No. 9, pp. 1317–1318, 1989.
Printed in Great Britain.

0305-750X/89 $3.00 + 0.00
© 1989 Pergamon Press plc

Editors' Introduction

IRMA ADELMAN
University of California, Berkeley

and

ERIK THORBECKE
Cornell University, Ithaca, New York

In November 1986, Erik Thorbecke and Irma Adelman organized a conference on the Role of Institutions in Economic Development under the auspices of the H. E. Babcock Chair and the Program on Comparative Economic Development at Cornell University.

Most of the papers initially presented fell into three main parts: (1) Theoretical and Conceptual Approaches to Institutions and Institutional Change; (2) Microeconomic Modeling of Institutions; and (3) Macroeconomic Evaluation of Institutions.

Part 1 of the volume contains five distinctive approaches to institutions and institutional change. The first paper by North is an application of the transaction costs approach to institutional change in Western Europe essentially from the feudal period to the early 20th century. It demonstrates clearly the impact of changing transaction costs, in turn influenced by population growth, on institutions and changing property rights. The second paper by Nabli and Nugent provides a detailed and rigorous analysis of the impact of transaction costs on different institutions and institutional arrangements in developing countries. It contains a large number of specific examples covering a variety of different settings. It also explores how collective action can influence institutions.

The third paper by Streeten paints with a broad and incisive brush a picture of global institutions for an interdependent world. After a brief discussion of some necessary conditions for an international order concerned with development, a distinction is drawn between the exchange system, the threat system and the integrative system. Examples of typical prisoners' dilemma situations are rehearsed and global reforms suggested.

The next paper by Leibenstein puts a magnifying glass on the organization (both public and private) as a black box in economic development. X-efficiency theory is applied to the analysis of organizations and state enterprises with special reference to developing countries. By adopting appropriate conventions within organizations, it is shown that different parties can all benefit.

The final paper in Part 1 is by Ruttan, who develops the concept of induced institutional change. He shows with examples based on Japan, the United States and developing countries that changing resource endowments (and, in particular, the increasing cost of labor) induce new labor-saving technologies. He also presents a general model of institutional change based on the interactions among four elements: resource endowment, cultural endowment, technology and institutions.

The second part of the volume is devoted to the microeconomic modeling of institutions. The first paper by Bardhan deals with the choice of tenancy contracts and, in a more general sense, how rural institutions lead to interlinked transactions (combining wage, credit and output share contracts) and vice-versa. Given the crucial importance of rural institutions in the bulk of the Third World, this paper provides a concise analysis of the socioeconomic implications of these institutions — particularly in Asia.

The next paper in Part 2, by de Janvry and Sadoulet, uses a game-theoretical framework to analyze the reasons for the failure of significant land reforms in the Latin American context. It reveals that — given the balance of political power — the game played by large landlords, the State and campesinos, as main actors, is unlikely to result in meaningful land redistributions. The paper by Svejnar, likewise, uses a game-theoretical framework to study different industrial labor market institutions in developing countries. The paper argues that policy conclusions derived from existing theories of economic development

may be flawed because of an incorrect specification of the modern-sector labor market. In particular, the interrelationship between trade unions and governments is scrutinized and its effect on wages and employment analyzed.

The third part of the volume is devoted to a macroeconomic evaluation of institutions. It starts with a paper by Morris and Adelman examining the interaction between economic development and institutional change in the 19th century. On the basis of a quantitative study, it is argued that domestic institutional change was the most potent dynamic factor determining differences in the pace and structure of economic development among countries in the 19th century.

The second paper, by Montias, is also an historical evaluation of how many institutions acted as obstacles and brakes to development in socialist economies. The promotion of efficiency through system change had traditionally conflicted with the preservation of egalitarian values, the desire to maintain stability and xenophobia. The prospects for current reform in the Soviet Union and in Eastern Europe are examined in the light of these and similar considerations.

The next two papers by Ranis and Felix, respectively, concentrate on the impact of different international trade regimes and institutions on economic growth and income distribution in different parts of the Third World. The Ranis paper rejects both the claims of those who see the East Asian story as one of the applications of pure *laissez faire* and the more recent revisionist view that it all resulted from the activity of a highly intrusive government. Instead, it emphasizes the role of institutional and organizational changes orchestrated by a government which was both sensitive to these systems' initial conditions and to the importance of setting the stage for the fullest possible participation, through markets, of large numbers of disbursed private actors.

Felix analyzes the experience of the newly industrialized countries in East Asia following an outward-looking export strategy, and contrasts this experience with that of the inward-looking, import substitution industrialization strategy of most Latin American countries.

In the penultimate paper, Fields and Wan, likewise, contrast the lessons from Asia and Latin America in another area, namely, that of wage-setting institutions. It is shown that the Asian economies have relied more on market wage determination, whereas the Latin American economies have encouraged institutions which push wages to key sectors up above market-clearing levels. Market wage determination, combined with export-led growth, has resulted in rapidly rising real wages in the context of full employment in the Asian economies. Conversely, less reliance on market wage determination and inward-looking import substitution are thought to have negatively affected the performance of Latin American economies.

The final paper by Thorbecke, in collaboration with Morrisson, examines in some detail the impact of institutions and policies on agricultural performance over a 25-year period (1960–85), within a comparative analysis of six individual case studies of poor developing countries (Burkina Faso, Mali, Kenya, Tanzania, Nepal and Sri Lanka). A number of policy inferences and generalizations are drawn from the comparative experience of these countries. In particular, the delicate process through which the agricultural surplus is transferred to nonagriculture is explored over time and the relationship between the State and farmers is analyzed.

World Development, Vol. 17, No. 9, pp. 1319–1332, 1989.
Printed in Great Britain.

0305–750X/89 $3.00 + 0.00
Pergamon Press plc

Institutions and Economic Growth: An Historical Introduction

DOUGLASS C. NORTH*
Washington University, St. Louis, Missouri

Summary. — In this essay the interdependence of political and economic institutions is examined against premises in neoclassical theories of economies, which maintain that population and savings are the principal determinants of economic growth. That institutions matter in the development of economics is the difference in assumptions I examine. I look at the institutional frameworks that preceded adoption of the United States Constitution and the Northwest Ordinance in early America. I then trace the precedents of these American institutions to the evolution of common law in England, where interests unconcerned with the Crown coalesced to form competing political units. I then contrast England's institutional development with the comparatively centralized enforcement mechanisms of Spain to examine the hypothesis that institutional differences produce economic consequences.

The objective of this essay is two-fold: (1) to develop a theoretical framework which focuses on the historical obstacles to economic growth; and (2) to briefly apply this framework to explore the contrasting characteristics of institutional change in early modern Britain and Spain and the downstream implications for North and Latin America.[1] In the sections that follow, I explore in: (1) the issues; (2) the nature of institutions; (3) the sources of institutional change; (4) the initial historical conditions in England and Spain; (5) English development; (6) Spanish development; and finally in section (7) the consequences for the New World. Of necessity, the historical sections are little more than outlines, illustrating the framework developed in the first sections.

1. THE ISSUES

I begin with one of the most cited but still misunderstood essays of our time. It is 25 years since Ronald Coase published "The Problem of Social Cost" (1960), but the impact of that essay has still not really penetrated the economics profession, or the development literature. Coase pointed out that the neoclassical model, which has served as the basis of economic reasoning for most scholars in the Western world, holds only under the severely restrictive assumption of zero transaction costs; but that with positive transaction costs, institutions matter. There are no institutions in the neoclassical world; and indeed in such a world growth is not a problem, its rate being simply a function of the number of children people have and the rate of saving.[2]

Ever since Adam Smith, economists have recognized that gains from trade are the key to the wealth of nations. Specialization and division of labor have made possible the improved productivity that arises from technological change, better resource allocation, and specialized production, the key underlying features of modern economies. What economists have not realized until recently is that the exchange process is not costless. Economists still misunderstand key dilemmas of economies and ignore the costs involved in exchange, assuming (as the standard neoclassicists do) that exchange is costless or unproductive (i.e., the classical notion of unproductive labor), or contending that such costs exist but are passive and therefore not important, or are neutral with respect to their consequences for economies.

In fact, the costs of transacting are the key to the performance of economies. There have always been gains from trade, as classical international trade theory has taught, but so too have there been obstacles to realizing these gains. If transport costs were the only obstacle, then we would observe through history an inverse rela-

*I wish to thank Elisabeth Case for improving this essay.

tionship between transport costs, on the one hand, and trade and exchange and the well-being of societies on the other. But recall that as early as the Roman Empire of the first two centuries AD trade was possible over a vast area, even with the transport costs of the time; and that after the end of the Roman Empire trade declined and probably the well-being of societies and individual groups declined as well. It was not that transport costs had risen; but that the costs of transacting had risen as regions expanded, and unified political systems that could effectively enforce rules and laws disappeared.

From the evidence of history, let us turn to the economies of the world today and observe the enormous disparity between the rich countries of the Western world and the poor countries of the Third World. It is not transport costs but the costs of transacting that are the key obstacles that prevent economies and societies from realizing well-being. We can understand why when we examine analytically the costs of transacting in different situations.

We begin with a simple model of personal exchange. In personal exchange individuals either engage in repeat dealings with others or otherwise have a great deal of personal knowledge about the attributes, characteristics, and features of each other. The measured transaction costs of a society where there is a dense social network of interaction are very low. Cheating, shirking, opportunism, all features that underlie modern industrial organization theory, are limited or indeed absent, because they simply do not pay. Under such conditions, norms of behavior are seldom written down. Formal contracting does not exist, and there are few formal specific rules. However, while measured transaction costs in such societies are low (although unmeasured costs of societal cooperation in tribal societies may indeed be high), production costs are high, because specialization and division of labor are limited to the extent of markets that can be defined by personal exchange.

At the other extreme from personal exchange is a world of specialized interdependence in which the well-being of individuals depends upon a complex structure characterized by individual specialization and hence by exchange ties that extend both in time and space. A pure model of this world of impersonal exchange is one in which goods and services or the performance of agents is characterized by many valued attributes, in which exchange takes place over time, and in which there are not repeat dealings. Under these forms of exchange, the costs of transacting can be high, because there are problems both in measuring the attributes of what is being exchanged and problems of enforcing the terms of exchange; in consequence there are gains to be realized by engaging in cheating, shirking, opportunism, etc.[3] In order to prevent such activity, elaborate institutional structures must be devised that constrain the participants and so minimize the costly aspects I have just described. As a result, in modern Western societies we have devised formal contracts, bonding of participants, guarantees, brand names, elaborate monitoring systems, and effective enforcement mechanisms. In short, we have well-specified and well-enforced property rights. The result of all this is that resources devoted to transacting (although small per transaction) are large, while the productivity associated with the gains from trade is even greater; and high rates of growth and development have characterized Western societies. Of course these institutions depend on a much more complex institutional structure that makes possible the specification and enforcement of property rights, which in turn allow transactions to occur and productivity gains from modern technology to be realized.

Increasing specialization and division of labor necessitate the development of institutional structures that permit individuals to take actions that involve complex relationships with other individuals both in terms of personal knowledge and over time. The evolution of more complex social frameworks will not occur if such institutional structures cannot reduce the uncertainties associated with such situations. So, institutional reliability is essential, because it means that even as the network of interdependence caused by the growth of specialization widens we can have confidence in outcomes that are necessarily increasingly remote from our personal knowledge.[4]

The institutional requirements that are necessary in order to be able to realize the productivity gains associated with the model of impersonal exchange outlined above entail both the development of efficient products and factor markets and of a medium of exchange with reliable features. The establishment of such a set of property rights will then allow individuals in highly complex interdependent situations to be able to have confidence in their dealings with individuals of whom they have no personal knowledge and with whom they have no reciprocal and ongoing exchange relationships. This is only possible as the result, first, of the development of a third party to exchanges, namely government, which specifies property rights and enforces contracts; and second of the existence of norms of behavior to constrain the parties in interaction, which will permit exchange where high measurement costs,

even with third party enforcement, pose problems with respect to opportunism, cheating, etc.

But why isn't it automatic to develop more and more complex institutions that will enable us to handle more complex interdependence? Indeed, much of the literature of game theory and stories of institutional development imply that the progress of primitive societies to the status of modern Western societies should be automatic and unilinear. The answer is quite clear. The breakdown of personal exchange is not just the breakdown of a dense communication network, but is the breakdown of communities of common ideologies and of a common set of rules in which all believe. The rise of impersonal rules and contracts means the rise of the state, and with it unequal distribution of coercive power. This provides the opportunity for individuals with superior coercive power to enforce the rules to their advantage, regardless of their effects on efficiency. That is, rules will be devised and enforced on behalf of the interests of the politically advantaged but they will not necessarily lower the costs of transacting in total.

In fact, one of the most evident lessons from history is that political systems have an inherent tendency to produce inefficient property rights which result in stagnation or decline. There are two basic reasons for this result. First, the revenue that can be raised by rulers may be greater with an inefficient structure of property rights that can, however, be effectively monitored, and therefore taxed, than with an efficient structure of property rights with high monitoring and collection costs.[5] Second, rulers can seldom afford efficient property rights, since such rights can offend many of their constituents and hence jeopardize the security of others' rights. That is, even when rulers wish to promulgate rules on the basis of their efficiency consequences, survival will dictate a different course of action, because efficient rules can offend powerful interest groups in the polity.[6]

2. THE NATURE OF INSTITUTIONS

Institutions are rules, enforcement characteristics of rules, and norms of behavior that structure repeated human interaction. Hence, they limit and define the choice set of neoclassical theory. We are interested not in the institutions *per se*, but in their consequences for the choices individuals actually make.

Constitutions, statute and common laws, and contracts specify in formal terms the rules of the game, from the most general constitutional ones to the specific terms of a particular exchange. Rules (and their enforcement) are constrained by the costliness of measuring the characteristics or attributes of what constitutes rule compliance or violation. Hence, the technology of measurement of all the dimensions (sight, sound, taste, etc.) of the human senses has played a critical role in our ability to define property rights and other types of rules. Moreover, since we receive utility from the various attributes of goods and services rather than from the entities themselves, it is the costliness of measuring the separable dimensions that is critical in this study. The relationship between the benefits derived from rule specification and the costs of measurement not only has been critical in the history of property rights (common property vs. private property) but is at the heart of many of the issues related to the structure and effectiveness of enforcement.

If it were costless to measure the performance of agents or the attributes of goods and services as well as the terms of exchange, then enforcement would not be a problem. We would be back in the neoclassical world of the instantaneous exchange of a unidimensional good or service. But because measurement is costly and the parties to exchange stand to gain by receiving the benefits without incurring all of the costs of exchange, not only is enforcement typically imperfect, but the structure of the enforcement process will affect outcomes and hence choices. Let me elaborate both points.

Enforcement is typically imperfect for two reasons: measurement is costly; and the interests of principals and agents are not identical. The costliness of measurement implies that at the margin the benefits from additional monitoring or policing will be balanced against the incremental costs. Moreover, as I shall discuss below, the marginal benefits and costs of policing will be weighed against those of investing at the margin in ideological persuasion. Rules are enforced by agents (police, foremen, judges, juries, etc.), and therefore the standard problems of agency theory obtain. It is important to stress here that both the structure of the enforcement mechanism and the degree of imperfection of enforcement are important in the choices that are made.[7]

Rules and their (imperfect) enforcement are not the complete story. If they were, the modeling of institutions and hence the costs of transacting could be made, at this stage of our knowledge, much more precise. But norms of behavior also matter; and we know very little about them.

As a first approximation, norms are informal constraints on behavior that are in part derivative of formal rules; that is they are extensions of such

rules and apply to specific issues. These informal procedures, deriving as they do from formal organizational structures and agendas, are important but still relatively easy to analyze.[8] Much more important, norms are codes of conduct, taboos, standards of behavior, that are in part derived from perceptions that all individuals form both to explain and to evaluate the world around them. Some of these perceptions are shaped and molded by organized ideologies (religions, social and political values, etc.). Others are honed by experience, which leads to the reaffirmation or rejection of earlier norms.

However they are formed, and however they evolve, norms play a critical role in constraining the choice set at a moment of time and in the evolution of institutions through time. They are important at a moment of time precisely because of the costliness of measurement and the imperfect enforcement of rules. To the degree that individuals believe in the rules, contracts, property rights, etc., of a society, they will be willing to forego opportunities to cheat, steal or engage in opportunistic behavior. In short, they live up to the terms of contracts. Conversely, to the degree that individuals do not believe in the rules, regard them as unjust, or simply live up to the standard wealth maximizing behavioral assumption we typically employ in neoclassical economics, the costs of contracting, that is transaction costs, will also increase. Empirical evidence suggests the price we are willing to pay for our convictions is a negatively sloped function, so that ideological attitudes are less important as the price increases; but both the slope of the function and shifts in the functions are subjects about which we know very little.[9]

The foregoing paragraphs suggest that ideas and values matter at a moment of time. They do so because of "slack in the system," "agency costs," "consumption on the job," etc., all of which result from the costliness of measurement and enforcement. But how do they change through time? Certainly fundamental changes in relative prices lead not only to rule (and enforcement) changes; but to changes in ideas and values, and the rate of these two kinds of change may be markedly different. This subject will be explored below, but first let me raise some specific issues about institutions, transaction costs, and the consequent choices of the "players," which bear on the subject of this essay.

Let me start with a quotation from Bill Riker.

> . . . Every time I convince myself that I have found an instance in which constitutional forms do make a difference for liberty, my discovery comes apart in my hands. . . . Professor Ostrom believes that at least part of the reason we believe we are a free people is that we have certain constitutional forms, but it may just as easily be the case that the reason we have these constitutional forms is that we are a free people.[10]

Now let me quote Bill Riker, a decade later.

> The Constitution was in a formal sense a necessary condition for the achievement, that is had the Articles [of Confederation] survived, the nation would not have flourished. To see this, note the Constitution was, in a formal sense, necessary for political unity and the consequent political dominance of the United States, first in America and its expansion westward, then in the western hemisphere by restraining European empirical expansion and finally in the world, helping to destroy in two world wars Western European monarchies and empires and later in countering the Soviet empire. All this depended on political unity. Yet without the Constitution, North America might very well have been as Balkanized as South America.[11]

Rules themselves are not a sufficient condition for determining outcomes even though they are, on occasion, critical. Indeed, the second quotation is from an extraordinarily insightful analysis of the formation of the Constitution, in which Riker makes the convincing case that its creation results from a rather unique concatenation of events that, as the quote implies, changed the destiny of the 13 confederated states. But it is important to remember that a number of Latin American countries patterned their constitutions after that of the United States with radically different results.

It may be a slight exaggeration to assert that enforcement is always imperfect, but this statement focuses our attention on a critical and neglected aspect of economic history, which is the essential role that third party enforcement of contracts has played in human economic progress. There is a large literature in the new industrial organization on self-enforcing contracts, etc.; but as with so much of modern economics, it misses the larger issues involved in exchange in a specialized world. Personal exchange solves the problems of contract fulfillment by repeat dealings and a dense network of social interaction. But the key to the high-income societies of the Western world is still the one that Adam Smith propounded more than 200 years ago. Increasing specialization and division of labor necessitate the development of institutional structures that permit individuals to take actions involving complex relationships with other individuals far removed from any personal knowledge and extending over long periods of time. This is only possible with a third party to exchange, government, which specifies property rights and enforces contracts.

Let me emphasize that while third party enforcement is far from perfect, there are vast differences in the relative certainty and effectiveness of contract enforcement, temporally over the past five centuries in the Western world, and more currently between modern Western and Third World countries. The evolution of government from its medieval Mafia-like character to that embodying modern legal institutions and instruments is a major part of the history of freedom. It is a part that tends to be obscured or ignored because of the myopic vision of many economists, who persist in modeling government as nothing more than a gigantic form of theft and income redistribution.

In a recent paper, Robert Axelrod tells the story of Alexander Hamilton writing, on the last night of his life, all of the reasons why he should not engage in a duel with Aaron Burr.[12] They were rational and overwhelmingly convincing reasons but in the end not sufficient to overcome the dishonor that he perceived would result from a code of conduct that required such a solution of disputes among gentlemen. Axelrod's purpose in telling this story was to illustrate that norms of behavior, which are not legal rules, are enforced by the attitudes and behavior of others in the society.

But this is surely only part of that complex of ideas, customs, dogmas, values, ethical standards, etc., which make up our understanding of the world around us, establish our normative standards, and help define the choices we make. While some norms are externally enforced, others are internally enforced codes of conduct, like honesty or integrity. It would be an immense contribution to have a testable general theory of the sociology of knowledge and therefore an understanding of the way overall ideologies emerge and evolve.[13] In the absence of such a theory, we can still derive an important and potentially testable implication about norms at a more specific microlevel of analysis, which is derived from an understanding of institutions. Specifically, the structure of rules and their enforcement help define the costs we bear for ideologically determined choices; the lower the costs, the more will ideas and ideologies matter. Let me provide three illustrations.

A basic paradox of public choice is that individual votes do not matter, but lots of people still vote. Brennan and Buchanan point out this dilemma in a recent paper but do not satisfactorily resolve it.[14] Surely one of the things voters are doing is expressing strongly held convictions at low cost to themselves. Moreover, in the aggregate votes do of course matter. The expression "putting your money where your mouth is" characterizes neither voters nor for that matter academics. Both can afford to be in the literal sense, *irresponsible*.

Recently a large volume of literature has grown up around agency theory applied to legislators, with the voter as principal and the legislator as agent. Empirical work suggests that legislators frequently vote their own conviction rather than principals' interests.[15] Other empirical work suggests that the institutional structure of Congress permits legislators to engage in strategic voting behavior that effectively conceals their true objectives.[16]

Finally, judges with lifetime tenure can and do vote their own convictions, as even the most casual study of courts in general and the Supreme Court in particular testifies. Moreover, this is not an accident. The constitutional provisions, as interpreted by the Marshall Court (1801–35), were deliberately designed to remove judges from interest group pressures.[17]

However possible it is to show that ideas matter, it is much more difficult to trace the way they have evolved. For example, the demise of slavery is simply not explicable in an interest group model. Surely the micro argument described above is important to understanding its end. That is, most of those who voted for its elimination, either directly or indirectly, paid few or no costs; they could simply express their abhorrence of one human being owning another. There was no institutional way for the slave owner to buy off the voters. On the other hand, the *way* in which the anti-slavery movement grew (and frequently was used by interest groups) so that it could lead to these votes is a much more complex story.

It is time we took stock. The neoclassical model describes the output of an economy as a function of the quantity and costs of a set of inputs of land, labor, capital and entrepreneurship, given some production function derived from the state of technological knowledge. But this formulation is, if not incorrect, largely misleading, since if that were all there were to the output of societies, they would all be rich (given again some rather noncontroversial behavioral assumptions). Restated more usefully, the costs of production are a function of the costs of the traditional inputs listed above and of the costs of transacting.

It is important to stress that economic growth can and has occurred as a consequence of increasing productivity. That is, either technological change or changes in institutions (political or economic) that affect the specification and enforcement of property rights may increase productivity.

The measurement of transaction costs is beset with all of the problems of measurement in traditional national income accounting. To the extent that transactions occur in the market economy, they can be measured.[18] However, costs of transacting arising from queuing, waiting, rationing, bribery, etc., which are substantial in all economies but particularly in Third World and socialist economies, are unmeasured.

In considering historical measurement we must remember that the costs of transacting have frequently been so high that no production or exchange occurred. The lack of institutions and instruments to facilitate production and exchange in factor and product markets (as well as the existence of institutions designed to raise the costs of transacting) resulted in predominantly personalized (and localized) production and trade. The development of institutions to facilitate transacting is marked not only by expansion of production and exchange in particular factor markets, but by a subsequent decline in transaction costs as the institutions develop. The dramatic decline in real interest rates in 17th century Netherlands and early 18th century Britain followed the development of capital market institutions; it is probably the best quantitative measure (and the most critical indicator) of improving productivity in the transactions sector.

The foregoing discussion profiles transaction costs in a growing economy. The emergence of political institutions that specify "efficient" property rights and provide increasingly effective enforcement should show up in terms of the development of economic institutions to facilitate market exchanges. As a result, costs per transaction will be falling; but the size of the transactions sector in the aggregate will be a growing proportion of GNP, as increasing specialization and division of labor multiplies the aggregate volume of exchanges. This is precisely the pattern for the United States, where the measured size of the transaction sector in 1870 is about one-quarter of GNP and in 1970 is almost one-half.

3. THE SOURCES OF INSTITUTIONAL CHANGE

There are two issues I wish to address on institutional change: what causes the change; and what determines its path? In neither case have I a completely satisfactory answer.

Before we can turn to these two issues, we must examine the role institutions play in reducing uncertainty in human interaction, since it is this stabilizing role of institutions which separates clearly the framework of analysis being developed here from the traditional neoclassical approach. We can most readily understand the difference if we have ever visited foreign countries and attempted to "do business" with them. We will find that of necessity we must learn their "way of doing things." The structural forms of human interaction that characterize societies are a combination of rules, enforcement features, and norms of behavior. Until we learn what these are, the costs of transacting are high. Once we understand them, we can effectively communicate and engage in varieties of social, political, and economic exchange. The function of institutions is to provide certainty in human interaction, and this is accomplished by the inherent features of rules and norms. Rules are typically nested in a hierarchical structure, each more costly to change. But even in the absence of the hierarchical institutional structure, the status quo typically has an advantage over changes in a variety of political structures, as a consequence of agenda control and committee structure.

It is norms of behavior, however, that probably provide the most important sources of stability in human interaction. They are extensions, elaborations, and qualifications of rules that have tenacious survival ability, because they become an integral part of habitual behavior. The reduction of uncertainty, in consequence, makes possible regular human interaction; but it in no way implies that the institutions are efficient, only that they dampen the consequences of relative price changes.

But institutions do change, and fundamental changes in relative prices do lead to institutional change. Historically, population change has been the single most important source of relative price changes, though technological change (including and importantly, changes in military technology) and changes in the costs of information have also been major sources. Moreover, as briefly noted in the previous section, changes in norms of behavior, while certainly influenced by relative price changes, are also influenced by the evolution of ideas and ideologies.

A stylized characterization of the process of institutional change could proceed as follows: as a result of a relative price change, one or both parties to an exchange (political or economic) perceives that he (they) could do better with an altered agreement (contract). Depending on his relative (and presumably changed) bargaining power, he will, as a consequence of the changed prices, renegotiate the contract. However, contracts are nested in a hierarchy of rules. If the renegotiation involves alteration of a more fundamental rule, he (or they) may find it

worthwhile to devote resources to changing the rule; or gradually, over time, the rule or custom may simply become ignored and/or unenforced. Agenda power, free-rider problems, and norms of behavior will add meat (and lots of complications) to this skeletal outline.

An important distinction in this argument is made between absolute bargaining power and changes at the margin. To illustrate this distinction, I turn to the medieval world. The "agreement" between lord and serf on the medieval manor reflected the overwhelming power of the lord vis-à-vis the serf. But changes at the margin, as a consequence of 14th century population decline, altered the opportunity costs, increased the relative bargaining power of serfs, and led to the gradual evolution of copyhold.[19]

While institutional evolution may proceed in the above manner, without explicit intent or design, dramatic changes in the rules (or their enforcement) occur as well. The gathering in Philadelphia in 1787 is a clear example. Riker, in the essay referred to above, makes clear that the instigators of the convention were Federalists and that their opposition both misunderstood and misjudged their ability to write and ratify a new constitution. Indeed, it was the promised addition of the Bill of Rights as the first order of business under the new constitution that made ratification possible (Riker, forthcoming). Perhaps it is worth noting that the writers were "gentlemen" and that their promise was both believed and carried out.

A special note should be made of the role of military technology in institutional change. Not only have changes in military technology resulted in different, efficient (survival) sizes of political units, but, as in the story that follows, they have consequently induced fundamental changes in other institutions, so that fiscal revenues essential to survival could be realized

The second issue of institutional change is what determines the direction of change. From what must have been quite common origins several million years ago or even as recently as the hunting and gathering societies that predate the "agricultural revolution" in the 8th millenium BC, we have evolved in radically different directions (and at radically different rates). How have we evolved such divergent patterns of social, political, and economic organization? To consider a specific example, as I will do in the subsequent sections of this paper, how do we explain the divergent paths of British and Spanish development, both at home and in the contrasting histories of North and South America?

I believe the answer lies in the way that institutional structures evolve. The closest (although by no means perfect) analogy is the way we perceive that the common law evolved. It is precedent-based law: past decisions become embedded in the structure of rules, which marginally change as cases arise evolving some new or, at least in the terms of past cases, unforeseen issue, which when decided becomes, in turn, a part of the legal framework. However, I don't intend to imply by this analogy that the result is "efficient." In fact, as we shall see, Spanish institutional evolution moved in the direction of stagnation.

Let me illustrate evolution by reference to a specific act, which was almost as important as the Constitution in United States history. This was the Northwest Ordinance, passed by the Congress (when it was under the Articles of Confederation) in 1787, at the very time that the Constitutional Convention was meeting in Philadelphia. It was the third act dealing with the issues that arose with respect to the settlement, governance, and integration of the vast lands to the west in the new nation. Where did the rules incorporated in these acts come from and how were they arrived at?

The Ordinance is quite simple and brief. It provided for rules of inheritance and fee-simple ownership of land: it set up the basic structure of the territorial governments and provided for the mechanisms by which territories gradually became self-governing. Additionally, it made provisions for when a territory could be admitted as a state. Then there was a series of Articles of Compact, in effect a bill of rights for the territories (i.e., provisions for religious freedom, the writ of *habeas corpus*, trial by jury, bailment, enforcement of contract and compensation for property). There were additional provisions about good faith to the Indians, free navigation on the Mississippi and the St. Lawrence, public debt, land disposal, the number of states that could be divided up within the Northwest Territory, and finally a provision prohibiting slavery (though the return of runaway slaves was provided for) in the territories.

It is easy to trace most of the provisions. Inheritance laws, fee-simple ownership of land, and many of the provisions of the Bill of Rights had evolved and become a part of the rules of political units of the colonies during the previous 150 years (described in more detail below). However, some that were precedent-based in the territorial charters became controversial as new issues arose. The size of new states and the conditions admitting them were two such issues. Precedents originated in the provisions of charters and the Articles of Confederation.

Controversies arose from the implications of shifting political powers under the new government of the Constitution. The prohibition of slavery in new states, for example, appears to be the result of vote-trading between the authors of the Northwest Ordinance and the writers of the Constitution; slavery would be prohibited in the Northwest territories if counting slaves as three-fifths of a person were accepted in the Constitution, a policy that would increase the representation of Southern slave states in Congress (already a major issue of the period).[20]

The Northwest Ordinance provided the basic framework dictating the pattern of expansion of the American nation over the next century. While its provisions were at times modified by new issues and controversies, it provided a clear, "path-dependent" pattern of institutional evolution. It is only understandable in terms of precedent, new issues, and the bargaining strength of the parties. It is essential to note that precedents not only defined and determined many of the provisions but also dictated the existing agenda, decision rules, and method of resolution. The larger point of this illustration is that we can only understand historical change by modeling the way institutions evolved through time. That brings us to the following brief outline of English and Spanish institutional change, from the 1500s to the 19th century in North America and Latin America.

4. INITIAL HISTORICAL CONDITIONS IN ENGLAND AND SPAIN

Despite the similarities between England and Spain (discussed below) at the beginning of the 16th century, the two countries had evolved very differently. Spain had just emerged from seven centuries of Moorish domination of the peninsula. It was not really a unified country. Although the marriage of Ferdinand and Isabella brought Castile and Aragon together, they continued to maintain separate rules, Cortes (parliaments), and policies. England, in contrast, had developed a relatively centralized feudalism as a result of the Norman conquest and, with the Battle of Bosworth (1485), had recently established the power of the Tudors.

Yet, in common with the rest of the emerging European nation states, they each faced a problem with far-reaching consequences: that a ruler required additional revenue to survive. The tradition was that a king was supposed to live on his own, which meant that the income from his estates, together with the traditional feudal dues, were his total revenue. The changes in military technology associated with the effective use of the cross-bow, long-bow, pike, and gunpowder enormously increased the cost of warfare and led to a fiscal crisis first described by Joseph Schumpeter (1919). In order to get more revenue, the king had somehow to make a bargain with constituents. In both countries, this initially led to the development of some form of representation on the part of the constituents in return for revenue, and in both countries, the wool trade became a major source of crown revenue. Thereafter, the stories diverge. We can better appreciate this divergence in the framework of a very simple model of the state, consistent with the framework developed in the previous sections of this essay.[21]

The king acts like a discriminating monopolist, offering to different groups of constituents "protection and justice," or at least the reduction of internal disorder and the protection of property rights, in return for tax revenue. Since different constituent groups have different opportunity costs and bargaining power with the ruler, there result different bargains. But economies of scale also exist in the provision of these (semi) public goods of law and enforcement. Hence, total revenue is increased, but the division of the incremental gains between ruler and constituents depends on their relative bargaining power; changes at the margin in either the *violence* potential of the ruler or the opportunity costs of the constituents will result in re-divisions of revenue increments. Moreover, the rulers' gross and net revenues differ significantly as a result of the necessity of developing agents (a bureaucracy) to monitor, meter, and collect the revenue; and all the inherent consequences of agency theory obtain here. The initial institutional structure that emerged in order to solve the fiscal crisis therefore looked similar in all the emerging nation states of Europe. A representative body (or bodies) of constituents, designed to facilitate exchanges between the two parties, was created. To the ruler it meant the development of a hierarchical structure of agents, which was a major transformation from the simple (if extensive) management of the king's household and estates to a bureaucracy monitoring the wealth and/or income of the king's constituents. Let us see how this initial framework evolved in the two cases.

5. ENGLISH DEVELOPMENT

The tension between rulers and constituents (although that would hardly describe the situation at Runnymede in 1215) surfaces with the

Magna Carta; but the fiscal crises come to a head with Edward I and Edward III during the Hundred Years War. Stubbs in his *The Constitutional History of England* (1896) summarizes the consequences.

> The admission of the right of parliament to legislate, to inquire into abuses, and to share in the guidance of national policy, was practically purchased by the monies granted to Edward I and Edward III.

A logical consequence was that in the 16th century under the Tudors the structure of Tudor government was revolutionized, as Geoffrey Elton has described in *The Tudor Revolution in Government* (1953). This revolution transformed the government from an elaborate household structure into a bureaucracy increasingly concerned with overseeing and regulating the economy. It had early on been the wool trade which had served as the basis for a good deal of tax revenue; and, as told by Eileen Powers (1941), the wool trade involved a three-way relationship between the exporters, the wool growers as represented in Parliament, and the Crown. In this agreement, the Merchants of the Staple achieved a monopoly of the export trade as well as a depot in Calais. Parliament received the right to set the tax and the Crown obtained the revenue. In England the combined mix of the growth of the wool trade, the development of fee-simple ownership in land, and the development of arable lands and new crops imported from the Dutch contributed to an expansion of agriculture. At the same time, in the nonagricultural sector the economy became increasingly diversified. Although the Tudors continued to attempt to control the economy and to freeze the structure of economic activity into guilds and monopolistic activities, their efforts were relatively ineffective. They were ineffective because (1) the statutes only covered existing industries, so that new industries escaped rule; (2) despite opposition by town guilds, industries moved to the countryside and effectively escaped guild control; (3) the control of wages and laborers in the Statute of Artificers of 1563 was only partially and sporadically enforced; and (4) enforcement in the countryside was typically in the hands of unpaid justices of the peace who had little incentive to enforce the law.

The cloth trade therefore grew in the countryside. The interplay between the expansion of diverse economic activities escaping from guild restrictions and the pressures for the development of parliamentary control over the sovereign came to a head with the Stuarts, with the fumbling efforts of James I, the continuing fiscal crises that occurred under Charles I, and the articulate opposition of Coke and others. It was Coke who insisted that the common law was the supreme law of the land, and who repeatedly incurred the anger of James I. It was Coke who led the parliamentary opposition in the 1620s, which established common law control over commercial law. By the end of Elizabeth's reign, a changing benefit-cost pattern of economic activity was emerging with the widening of domestic and foreign markets; the result was the expansion of voluntary organizations in the form of joint stock companies, and growing resentment against the crown-sponsored monopolies which excluded private companies from many of these growing markets. *Darcy vs. Allein* was only the most celebrated case reflecting this ongoing struggle to create a set of rights that would be outside the control of the monarchy. Passing the Statute of Monopolies was just another step in the ongoing process.

Yet the issue of the supremacy of Parliament hung in the balance for much of the 17th century. As the struggle continued, Parliament not only attempted to wrest from the King's control the granting of monopolies (as in the Statute of Monopolies), but also to protect itself from the King's wrath by establishing religious, civil, and political freedoms as well (such as the Petition of Right in 1628). It distorts the story, however, to think of it as a clear-struggle between an absolutist "oriented" king and a unified Parliament concerned with economic, civil, and political liberties.[22] As the Civil War attests, a complex of religious, economic, and political interests coalesced into armed camps. Moreover, the winning coalition one day could be in the minority the next day. Hence, there was persistent interest and concern with broadly based and impersonally guarded rights.

The final triumph of Parliament was produced in 1689, and in rapid consequence came a set of economic institutions reflecting the relatively increasing security of property rights. The creation of the Bank of England (1694) and the development of new financial instruments led to a dramatic decline in the cost of transacting and have been described as the English financial revolution. Both institutions and consequent falling transaction costs reflect increased security of the time dimension of property rights, a dimension critical to both a long-term capital market and to economic growth itself.

In terms of the very simple political model outlined in Section 2, the original trade of c[illegible] in rights to Parliament in return for revenues [illegible] as a product of the fiscal crises of the Hundred Years War. In the 17th century, the Tudors' tripartite

arrangement between the Crown, Parliament, and merchants granted further rights to Parliament in return for tax revenues (and still further rights were granted to the Commons by Henry VIII for support in his controversial seizure of church properties). In consequence, the Tudors required an organized bureaucracy to oversee tax collection and to regulate other parts of the economy. The triumph of Parliament in 1689 simply shifted the locus of decision making to Parliament, which raises the issue of why Parliament would not then proceed to act just like the King. Ekelund and Tollison argue:

> Higher costs due to uncertainty and growing private returns reduced industry demands for regulation and control in England. All this strengthened the emergent Constitutional democracy, which created conditions making rent-seeking activity on the part of both monarch and merchant more costly. When the locus of power to rent-seeking shifted from the monarch to Parliament . . . the costs of supply and regulation through legislative enactment rose, for reasons suggested by the theory of public choice.[23]

The framework of institutional evolution I have described suggests a somewhat more complicated story than Ekelund and Tollison provide. They assert, "While it is flattering to think that intellectuals affect public policy — surely they do to some extent — it seems completely out of character for economists to think that intellectual arguments could affect real magnitudes so strongly."[24] But the embedding of economic and political freedoms in the law, the interests of principals (merchants, etc.) in greater degrees of freedom, and the ideological considerations that swept England in the 17th century combined to play a role in institutional change.

6. SPANISH DEVELOPMENT

While the major steps in Spanish institutional evolution are not in question, nor is the final result, I do not believe that the specific steps along the way have been as clearly delineated as in the English story. (It should be emphasized that I am not nearly as familiar with the Spanish literature as with the English; but it is my impression that an explicit analysis of the evolution of property rights and their political origins has not been a focus of Spanish economic history.) However, some sketch is possible.

Prior to the union of Ferdinand and Isabella, the kingdom of Aragon (comprising approximately Valencia, Aragon, and Catalonia) had a very different character than Castile. Aragon had been reconquered from the Arabs in the last half of the 13th century and had become a major commercial empire extending into Sardinia, Sicily, and part of Greece. The Cortes, reflecting the interests of merchants "had already secured the power to legislate and even to limit the king's power to issue legislation under certain conditions" (Veliz, 1980, p. 34). In contrast, Castile was continually engaged in warfare, either against the Moors or in internal strife. While the Cortes existed, it was seldom summoned,

> and as nobility and clergy were exempt from financial exactions that could conceivably join them with representatives of the town in resisting additional levies by the Crown, they did not pose (that is the towns did not pose) a credible challenge . . ." (Veliz, 1980, p. 35).

In the 15 years after their union, Isabella succeeded in gaining control not only over the unruly warlike barons but over church policy in Castile as well. The result was a centralized monarchy in Castile; and it was Castile that defined the institutional evolution of both Spain and Latin America.

A major source of fiscal revenues was the Mesta (the sheep-herders guild), which in return for the right to migrate with their sheep across Castile provided the Crown with a secure source of revenue, but also with consequences adverse to the development of arable agriculture and the security of property rights, as well as with soil erosion.[25]

Within Castile the other chief source of revenue was the *alcaba*, a sales tax. But as the Spanish empire grew to become the greatest empire since Roman times, its major sources of revenue were increasingly external, derived from Sicily, Naples, the low countries, and the New World. Control internally over the economy and externally over the far-flung empire entailed a large and elaborate hierarchy of bureaucrats armed with an immense out-pouring of royal edicts. Over 400,000 decrees had been issued concerning the governance and economy of the Indies by 1635, an average of 2,500 a year since Columbus sailed first to the Indies (Veliz, 1980, p. 43). Designed to provide minute regulation of the economy, guilds also provided a vehicle for internal economic regulation. Price ceilings were imposed on grain and state-owned trading companies, and monopolistic grants provided control of external trade.

As the military costs of controlling the empire outstripped revenues (which declined with the revolt of the Netherlands and the gradual decrease in receipts of treasure), the Crown raised the internal tax (*alcaba*) from 1.2% to 10% and repeatedly went into bankruptcy, which . resolved through the seizure of properties and financial assets. The consequence was the de-

cline of the Spanish economy and economic stagnation.[26]

In terms of the foregoing model of the polity, the bargaining position of the Crown, vis-à-vis the Cortes, shifted in favor of the Crown and consequently resulted in the decline of the Cortes. The governance structure then became a large and elaborate bureaucracy and there were endless efforts by the Crown to control its far-flung agents. Indeed, the history of the control of the Indies is an elaborate story in agency theory, beginning as early as Isabella's recision of Columbus' policies toward the Indians in 1502. Distance magnified the immense problem of monitoring agents in the New World; but despite the dissipation of rent at every level of the hierarchical structure, the Crown maintained effective control over the polity and over the economy of the New World.[27]

7. CONSEQUENCES FOR THE NEW WORLD

It is likewise much easier to trace the institutional evolution of the English North American colonies than their Latin American counterpart. The initial conditions are in striking contrast. English America was formed in the very century when the struggle between Parliament and the Crown was coming to a head. Religious diversity, as well as political diversity in the mother country, was paralleled in the colonies. In the Spanish Indies, conquest came at the precise time that the influence of the Castilian Cortes was declining. The conquerers imposed a uniform religion and a uniform bureaucratic administration on the existing agricultural society.[28]

In the English colonies there was substantial diversity in the political structure of crown proprietary and charter colonies. But the general development in the direction of local political control and the growth of assemblies was clear and unambiguous. Similarly, the Navigation Acts placed the colonies within the framework of overall British imperial policy, and within that broad framework the colonists were free to develop the economy. Indeed, the colonists themselves frequently imposed more restrictions on property rights than did the mother country. (The exception was the effort of proprietors to obtain quit-rents from settlers in proprietary colonies, such as that of Lord Penn. The problem of enforcement and collection in the context of the availability of land resulted in very indifferent success.)

In the Spanish Indies, a bureaucracy detailed political and economic policy.

> . . . the *residencia* was the principal means employed by the king to keep viceroys and other functionaries under control. On the expiration of their term of office, all officials had to undergo the official investigation of their conduct. The fear of the residencia was frequently an incentive to serve the monarch well; it also limited any autonomous inclination of ambitious civil servants in the periphery of the empire (Veliz, 1980, p. 73).

As for the economy, the Marquis of Pombal, who was the Secretary of State for Foreign Affairs and War, and who "ruled like a virtual dictator" Portugal and its empire from 1755–77, is said to have stated:

> I find it absolutely necessary to bring all the commerce of this kingdom and its colonies into companies, then all merchants will be obliged to enter them, or else desist from trading, for they certainly may be assured that I know their interests better than they do themselves and the interest of the whole kingdom (Veliz, 1980, pp. 108–109).

Some merchants and the Lisbon Chamber of Commerce protested.

> Pombal properly dissolved the chamber and had several of its leading members imprisoned; the rest were regrouped under direct government supervision into a *Juntado Commercio* that dutifully approved all the minister's decisions (Veliz, 1980, p. 109).

The French and Indian War (1755–63) is the familiar breaking point in American history. British efforts to impose (very modest) taxes on colonial subjects, as well as to curb westward migration, produced a violent reaction that led through a sequence of steps to the Revolution, the Declaration of Independence, the Articles of Confederation, the Northwest Ordinance, and the Constitution: a sequence of institutional expressions that formed a consistent evolutionary institutional pattern, despite the precariousness of the process.

In the Spanish Indies the recurrent crises were over the efficiency and control of the bureaucratic machinery. The decline under the Hapsburgs and the revival efforts under the Bourbons led to restructuring of the bureaucracy and even some liberalization of trade (under the Bourbons) within the empire. But the control of agents was a persistent problem, compounded by efforts of the Creoles to take over the bureaucracy in order to pursue their own interests. To whatever degree the wars of independence in Latin America were a struggle between colonial control (of the bureaucracy and consequent polity and economy) and imperial control, the struggle was imbued with ideological overtones that stemmed for the American and French

401.

revolutions. Independence brought United States inspired constitutions, but with radically different consequences. In contrast to the United States, in Latin America, "The imaginative federal schemes and courageous attempts at decentralization had one thing in common after the first few years of republican independence: they were all tried but none worked. Some were disastrous; none survived."[29]

The contrasting histories of North and South America are perhaps the best comparative case that we have of the consequences of divergent institutional paths for political and economic performance. We are only just beginning to extend economic and political theory to the study of institutions.[30] I hope this historical introduction gives some indication of the promise of this approach for the study of economic history and economic growth.

NOTES

1. This essay is a combination of two earlier papers of mine, "Institutions, transaction costs and economic growth," prepared for a World Bank conference on the Political Economy of Poverty, Equity and Growth, and subsequently published in *Economic Inquiry* (North, 1988a), and "Institutions, economic growth and freedom: An historical introduction," prepared for a Liberty Fund Symposium on Economic, Political and Civil Freedom, and published in *Freedom, Democracy and Economic Welfare*, edited by Michael Walker (North, 1988b).

2. See North (1981), Chapter I, for an elaboration of the implications of the noeclassical model for economic growth.

3. See Lancaster (1966), Becker (1965), Cheung (1974), North (1981), and Barzel (1982) for an elaboration of the theory underlying this argument.

4. Heiner (1983) explores these issues in an interesting essay.

5. The granting of monopolies to guilds in Colbert's France produced this result.

6. For an elaboration of these points, see "A Neoclassical Theory of the State," in North (1981) and North (1984).

7. Oliver Williamson's (1975) approach differs from the approach developed in this essay for several reasons, but principally because he takes imperfect enforcement as a given (otherwise opportunism would never pay) rather than recognize that both the characteristics of the enforcement process and the degree of imperfection are essential in modeling institutions and to the costs of transacting.

8. See for example Shepsle and Weingast (1986).

9. See Kalt and Zupan (1984) for discussion of these issues.

10. Riker (1976).

11. Riker (forthcoming).

12. Axelrod (1985).

13. The immense literature on the subject from Marx and Mannheim to Merton is not very convincing, although Robert Merton's chapters written in 1949 are still a good summary of the state of the art.

14. Brennan and Buchanan (1983).

15. Kalt and Zupan (1984).

16. Denzau, Riker and Shepsle (1985).

17. Landes and Posner (1975) provide an interest group model of the Supreme Court, but the evidence simply does not support such an argument. See Buchanan (1975) and North (1978).

18. See North and Wallis (1987) for a lengthy discussion of the issues and measurement of the transaction sector in the American economy between 1870 and 1970.

19. See North and Thomas (1973) for a description of this process.

20. For an elaboration of these issues, see North and Rutten (1987).

21. This simple "neoclassical theory of the state" is elaborated in North (1981), Chapter 3.

22. Moreoever, it should be noted that the rights that Parliament had in mind were those of the nobility and the gentry.

23. Ekelund and Tollison (1981), p. 149.

24. Ekelund and Tollison (1981), p. 151.

25. The history of the Mesta (Klein, 1920) is an exception to my assertion that the history of Spanish property rights has not been told. For a summary of the effects of the Mesta on the development of property rights in Spain, see North and Thomas (1973), Chapter 10.

26. Fo
North

27. Fo
Chapte

28. "T
dinated
the Enc
progran
installin
p. 220)

Axelro
norm
No.
Barzel,
mark
(1982
Becker.
Econ
Brenna.

Bu.
judici
of La
Cheung
of La
Coase,
of La
Denzau
"Farq
home
79, N
Elton, C
(Cami
Ekelund
as a
Texas
Heiner,
Amer
560–5
Kalt, Jo
in the
nomic
Klein, J
Unive
Lancaste
theory
(1966)
Landes,
dent j
Journa
875–90
Lang, Ja
Englan
19
Me
(

110

26. For a more detailed account and sources, see North and Thomas (1973), Chapter 10.

27. For a more detailed account, see Veliz (1980), Chapter 3: "The Regalist Indies."

28. "The Indian population was subdued and subordinated by the new ruling class of Encomenderos. But the Encomendero class itself was the target of a royal program that reduced its political significance by installing a class of state office holders" (Lang, 1975, p. 220).

29. Veliz (1980), p. 151. Veliz provides a country-by-country summary account of the decline of democratic government and the revival of the "centralist" bureaucratic structure and tradition in Latin America (Chapter 7).

30. See North (1986) for an analysis of the "New Institutional Economics."

REFERENCES

Axelrod, Robert, "An evolutionary approach to norms," *American Political Science Review*, Vol. 80, No. 4 (1986), pp. 1095–1111.

Barzel, Yoram, "Measurement and the organization of markets," *Journal of Law and Economics*, Vol. 25 (1982), pp. 27–48.

Becker, Gary, "A theory of the allocation of time," *Economic Journal*, Vol. 65 (1965), pp. 493–517.

Brennan, Geoffrey, and James Buchanan, "Voter choice — Evaluating political alternatives," *American Behavioral Scientist*, Vol. 28 (1983), pp. 185–206.

Buchanan, James, "Comment on: 'The independent judiciary in an interest group perspective'," *Journal of Law and Economics*, Vol. 18 (1975), pp. 903–906.

Cheung, Stephen, "A theory of price control," *Journal of Law and Economics*, Vol. 17 (1974), pp. 53–69.

Coase, Ronald, "The problem of social cost," *Journal of Law and Economics*, Vol. 3 (1960), pp. 1–44.

Denzau, Arthur, William Riker, and Kenneth Shepsle, "Farquharson and Fenno: Sophisticated voting and homestyle," *American Political Science Review*, Vol. 79, No. 4 (1985), pp. 1117–1134.

Elton, Geoffrey, *The Tudor Revolution in Government* (Cambridge: Cambridge University Press, 1953).

Ekelund, Robert, and Robert Tollison, *Mercantilism as a Rent Seeking Society* (College Station, TX: Texas A & M Press, 1981).

Heiner, Ronald, "The origins of predictable behavior," *American Economic Review*, Vol. 73 (1983), pp. 560–595.

Kalt, Joseph, and Mark Zupan, "Capture and ideology in the economic theory of politics," *American Economic Review*, Vol. 74, No. 3 (1984), pp. 279–300.

Klein, Julius, *The Mesta* (Cambridge, MA: Harvard University Press, 1920).

Lancaster, Kelvin, "A new approach to consumer theory," *Journal of Political Economy*, Vol. 74 (1966), pp. 132–157.

Landes, William, and Richard Posner, "The independent judiciary in an interest group perspective," *Journal of Law and Economics*, Vol. 18 (1975), pp. 875–902.

Lang, James, *Conquest and Commerce: Spain and England in America* (New York: Academic Press, 1975).

Merton, Robert, *Social Theory and Social Structure* (Glencoe, IL: Free Press, 1949).

North, Douglass, "Institutions, transaction costs and economic growth," *Economic Inquiry*, Vol. 25 (July 1988a).

North, Douglass, "Institutions, economic growth and freedom: An historical introduction," in Michael Walker (Ed.), *Freedom, Democracy and Economic Welfare* (Vancouver, BC: The Fraser Institute, 1988b).

North, Douglass, "The New Institutional Economics," *Journal of Institutional and Theoretical Economics*, Vol. 142 (1986), pp. 230–237.

North, Douglass, "Government and the cost of exchange in history," *Journal of Economic History*, Vol. 44 (1984), pp. 255–264.

North, Douglass, *Structure and Change in Economic History* (New York: W. W. Norton, 1981).

North, Douglass, "Structure and performance: The task of economic history," *Journal of Economic Literature*, Vol. 16 (1978), pp. 963–978.

North, Douglass, "Sources of productivity change in ocean shipping, 1600–1850," *Journal of Political Economy*, Vol. 76 (1968), pp. 953–970.

North, Douglass, and Andrew Rutten, "The Northwest Ordinance in historical perspective," in David Klingaman and Richard Vedder (Eds.), *Essays in the Economy of the Old Northwest* (Athens, OH: The Ohio University Press, 1987).

North, Douglass, and Robert Thomas, *The Rise of the Western World* (Cambridge: Cambridge University Press, 1973).

North, Douglass, and John Wallis, "Measuring the transaction sector in the American economy, 1870–1970," in Stanley L. Engerman and Robert E. Gallman (Eds.), *Long-Term Factors in American Economic Growth*, Vol. 51 of the Income and Wealth Series (Chicago: University of Chicago Press, 1987).

Powers, Eileen, *The Wool Trade in English Medieval History* (London. The Clarendon Press, 1941).

Riker, William, "The lessons of 1787," *Carnegie Papers on Political Economy*, Vol. 7 (forthcoming).

Riker, William, "Comment on: 'American experiment in constitutional choice'," *Public Choice*, Vol. 27 (1976), pp. 13–15.

Schumpeter, Joseph, "Crisis of the tax state" (1919), reprinted in *International Economic Papers* (1934), pp. 5–8.

411

Shepsle, Kenneth, and Barry Weingast, "The institutional foundation of committee power," Political Economy Working Paper #105 (St. Louis, MO: Washington University, 1986).

Stubbs, William, *The Constitutional History of England* (London: The Clarendon Press, 1896).

Veliz, Claudio, *The Centralist Tradition of Latin America* (Princeton, NJ: Princeton University Press, 1980).

Williamson, Oliver, *Markets and Hierarchies* (New York: Free Press, 1975).

Se
place in
decades.
which b
(traditio
and pro
how inst
and diff
coalesce
others h
nomics (
The p
the NIE
First, the
are the s
a battle
paradigm
sociobiol
minating
lines of i
right, inc
the integ
and pref
group fo
sites for (
costs, or
rationalit
of rules
the deter

World Development, Vol. 17, No. 9, pp. 1333–1347, 1989.
Printed in Great Britain.

0305–750X/89 $3.00 + 0.00
© 1989 Pergamon Press plc

The New Institutional Economics and Its Applicability to Development

MUSTAPHA K. NABLI
Université de Tunis

and

JEFFREY B. NUGENT*
University of Southern California, Los Angeles

Summary. — The several remarkable developments in the social sciences which have come to be known as the New Institutional Economics (NIE) have not yet been fully exploited for analyzing the determinants and effects of institutional change in the context of development. This paper identifies two important components of the NIE and illustrates both (a) potential complementarities between them and (b) their applicability to various problems and policies in the long-term development of developing countries.

1. INTRODUCTION

Several remarkable developments have taken place in the social sciences in the last two decades. Conspicuous among them are those which both highlight the shortcomings of the (traditional) neoclassical economics paradigm and provide original and powerful insights into how institutions are created. Disparate in origin and differing in form, these developments have coalesced into what Williamson (1975, 1985) and others have dubbed the New Institutional Economics (NIE).

The pioneering contributions that constitute the NIE are noteworthy on several grounds. First, the institutions and their determinants that are the subject matter of NIE have long served as a battleground among the alternative leading paradigms, namely Marxian, neoclassical, and sociobiological. Second, NIE represents the culminating intersection of a number of different lines of investigation, each interesting in its own right, including the analysis of behavioral norms, the integration of persons with different tastes and preferences into voting coalitions, interest group formation, the problems of the prerequisites for (successful) collective action, transaction costs, organization theory, limitations on the rationality of human behavior, the emergence of rules of thumb for firm decision making, the determinants of firm structure, coordination problems, rent-seeking behavior, technological change and its relationship to institutional change and the determinants and effects of property rights. Third, many of these individual lines of investigation within the NIE are interdisciplinary, allowing for cross-fertilization and mutual stimulation among historians, sociologists, political scientists, psychologists, lawyers and, of course, economists.

Because of the field's rapid and multidirectional growth, it would be a monumental task indeed to synthesize it in its entirety. Hence, no such attempt is made here.[1] The purpose of this paper is to relate some of the most important strands of analysis that constitute the NIE both to one another and to the economics of development.

Of course, the importance of institutions to economic development has been mentioned frequently. It has been stressed not only in classic works such as Adam Smith's *Wealth of Nations*, and in the work of the institutionalists of the early 20th century, but also in the literature of modern development economics, ranging from

*The authors gratefully acknowledge the useful comments of Bruce Herrick, Timur Kuran, Ruud Picavet, Mark Rosenzweig and the participants at seminars at Cornell University and Tilburg University at which earlier versions of the paper were presented.

the qualitative, such as Myrdal (1968), and the semi-quantitative, such as Morawetz (1981), to the highly quantitative, e.g., Adelman and Morris (1967) and Morris and Adelman (1986). Institutions and their importance to development have also been made the exclusive subject of at least one development textbook (Gannagé, 1966), and an important feature of several others, including one of the most modern (Basu, 1984). Both these textbooks and Myrdal's monumental book make a plea for the importance of understanding the local environment, and in particular the relevant institutions, for the proper design of development policy. Myrdal and numerous others describe the institutions in developing countries (LDCs), and Adelman and Morris identify some statistical correlations between the level of development and various social, political and institutional indicators. Similarly, Scully (1988) demonstrates the statistical significance of the elements of an institutional framework on economic growth during the period 1960–80 in a cross-section of 115 countries. As recently as 1985, still another leading development economist, namely Henry Bruton (1985), called attention to the importance of institutions in development. What is remarkable, however, is that Bruton did so without even a single mention of the NIE or any of its elements.

As Theodore Schultz observed some years ago, economists are quick to preach the merits of appropriate institutional changes, but in their analytical models they generally leave no room for or even make mention of institutions. "It is a neat trick, but it cannot hide the fact that, in thinking about institutions, the analytical cupboard is bare . . ." (Schultz, 1968, p. 1113).

Although in our view the NIE provides the relevant theoretical structure, there does not yet exist any systematic attempt to apply the NIE as a whole to development.[2] Despite a growing number of individual applications in various fields including development, NIE's impact on the economics of development has thus far been extremely limited.[3] Moreover, without such an impact, the economics of development may be in serious trouble as the following statement of Sir Arthur Lewis suggests:

> Development Economics will certainly die if they (Ph.D. students) come to think, rightly or wrongly, that work on economic institutions will not count for distinction in Ph.D. exams (Lewis, 1984, p. 8).

In view of the *many* applications of the NIE to fields such as industrial organization, health economics, macroeconomics and international trade within economics (to name only a few) and even to international relations and politics, the *dearth* of published applications to development economics is rather surprising. Furthermore, because the process of economic development is a long-term one in which institutions change and hence cannot safely be assumed to remain constant as in some of these other areas of economics, the shortage of applications (with the notable exceptions indicated below) of the new institutional analysis to development is not only surprising but also quite disturbing.

The objective of this study is to show the relevance of the principles and insights of the NIE to the analysis of the problems of LDCs. In our forthcoming book (Nabli and Nugent, forthcoming) we demonstrate this with applications of NIE to a wide range of institutional forms and issues in a single country, Tunisia.

2. DEFINING INSTITUTIONS

The consensus on the centrality of institutions to development has not been matched by one on its definition. Different authors have used quite different definitions, each emphasizing quite different aspects or characteristics of the more general phenomenon. Among the characteristics or aspects of institutions which vary are the degree to which they are (a) organizational, i.e., the extent to which organizations and institutions coincide, (b) formal, (c) created at a specific time and place by a specific means, as opposed to having evolved from more diffuse sources, (d) embedded in, as opposed to differentiated from, other institutions, (e) universal, as opposed to particularistic, in the interests they serve, (f) creating, as opposed to simply maintaining, a certain public good, and (g) technology linked.

There is also disagreement as to whether institutions can best be understood from a behavioral perspective in which "institutions are complexes of norms of behavior that persist over time, by serving collectively valued purposes" (Uphoff, 1986, p. 9) or from a rules perspective wherein "institutions are the rules of a society or of organizations that facilitate coordination among people by helping them form expectations which each person can reasonably hold in dealing with others" (Ruttan and Hayami, 1984, p. 204).

The difference between the two perspectives would seem to be related to the level and sequence of analysis. For example, at a relatively "low" level of analysis, e.g., that of contractual arrangements, the rules characteristic may dominate but at a relatively "high" level of analysis, such as that of cultural values and mores, the behavioral norms definition may seem more relevant. Similarly with respect to se-

quence, while at a given point in time the rules and norms that characterize institutions may be considered as given and independent of individual or group behavior, over time they may well evolve as a result of the preceding experience. Over time, therefore, we may observe dynamic chains going from rules to behavioral regularities to rules, etc. In any case, in most definitions there appear to be three more or less explicitly stated characteristics which may be considered basic to the concept of a social institution.

The first such characteristic is the rules and constraints nature of institutions. Elinor Ostrom (1986) has defined these rules and constraints as "prescriptions commonly known and used by a set of participants to order repetitive, interdependent relationships. Prescriptions refer to which actions are required, prohibited or permitted" (Ostrom, 1986, p. 5). It is important in terms of institutional analysis to consider configurations of rules rather than single rules separately. It is as sets or configurations that rules are considered as basic characteristics of institutions.

The second characteristic of institutions is their ability to govern the relations among individuals and groups. Whether they are "voluntarily" accepted through custom or tradition, or are enforced and policed through an external authority and a coercive incentive system, to serve an institutional role these rules and constraints have to be applicable in social relations.

The third characteristic of institutions is their predictability. The rules and constraints have to be understood, at least in principle, as being applicable in repeated and future situations. Agents should expect these rules and constraints to have some degree of stability; otherwise, they would not have an institutional character.

For present purposes an institution is defined as a set of constraints which governs the behavioral relations among individuals or groups. Formal organizations, such as labor unions and employers' organizations are institutions because they provide sets of rules governing the relationships both among their members and between members and nonmembers. Likewise, markets, be they stock exchanges, labor markets, credit markets, wholesale markets or traditional bazaars (*suqs*), are institutions because they embody rules and regulations, formal or informal, which govern their operation. Contracts, explicit or implicit, are also institutions in that they lay down rules which govern specified activities involving the parties to such contracts. Similarly, cultural rules and codes of conduct are institutions in so far as they, too, can constrain the relationships between different individuals and/or groups.

It is the purpose of the NIE not only to explain the determinants of institutions and their evolution over time but also to evaluate their economic efficiency and distributional implications. Since institutions generally attempt to satisfy certain goals and adopt structures such as incentives, the division of labor, rules for entry, exit, decision making and external relations, all such aspects of institutions should be considered in explaining institutions and their effects.

3. THEMES IN THE NIE

In mainstream neoclassical economics, four main types of constraints have received considerable attention: individual preferences, technological opportunities, physical and human capital endowments and market opportunities. In such analyses the institutional framework has almost invariably been taken as given, and in many cases has even been altogether omitted. The consequence of taking the institutional framework as given has been to leave the analysis of institutional constraints to noneconomists (typically political scientists, lawyers, sociologists, and anthropologists). While the analyses of noneconomists are rich in descriptive detail, and while they contain numerous useful insights, they tend to be relatively light in their ability to provide either reliable generalizations or a sound logical basis for policy choices. Without a place to fit such insights into their framework, most economists have unfortunately remained oblivious to the results of such analyses. The explicit or implicit assumption of given institutions is, of course, especially unrealistic and limiting in the context of economic development, a process whereby institutions generally undergo substantial change.

The goal of the NIE is to overcome these important limitations of mainstream neoclassical economics. Like most other intellectual developments, the NIE has evolved from earlier ideas. In particular, one important forerunner was Marxian analysis in which institutions were relatively exclusively determined by technology. Institutional changes, however, would necessarily arise from internal contradictions, i.e., a dialectic process which may be anything but smooth and comfortable (de Janvry, 1981). Marxists identify these processes with class struggles but fail to provide "micro-foundations" of just how they work. Significantly, however, this challenge has recently been taken up with collective action

415

theory by several Marxian scholars, such as Elster (1985), Offe (1985) and Roemer (1978). Sociobiologists have tended to emphasize that differences in biological and environmental forces have triggered different kinds of social and cultural responses which eventually solidify into institutions (Jones, 1981; Norgaard, 1981). Another important forerunner to and motivator of NIE was the Institutionalist School, which included such eloquent and prolific contributors as Thorstein Veblen, John R. Commons, Wesley Mitchell and Clarence Ayres. Indeed, the NIE resembles the earlier or "old" Institutionalist School in several important respects. Both are extremely broad in scope and replete with many interesting and diverse perspectives. More importantly, the two schools share a strong criticism of neoclassical economics for (a) its lack of attention to institutions and hence to the relevance and importance of nonbudgetary constraints, (b) its overemphasis on the rationality of decision making, (c) its excessive concentration on equilibrium and statics as opposed to disequilibrium and dynamics, and (d) its denial that preferences can change or that behavior is repetitive or habitual.

The NIE departs from the earlier Institutionalist School in that its critique of mainstream economics is a largely positive one. The NIE attempts to modify or broaden the mainstream toolkit and then to use this broadened analytical framework to explain phenomena that had previously seemed impenetrable. As Langlois (1986a, p. 5) puts it, "the problem with many of the early Institutionalists is that they wanted an economics with institutions but without theory; the problem with many neoclassicists is that they want economic theory without institutions; what NIE tries to do is to provide an economics with both theory *and* institutions."

The NIE is not, however, a homogeneous and monolithic body of knowledge. While it is essentially microeconomic in perspective, it includes various approaches, each with its own techniques and concepts and advantages and disadvantages, for analyzing institutions. While there is as yet no consensus on what is included in the NIE, we find that two broad and general approaches are salient, namely transaction and information costs, on the one hand, and the theory of collective action, on the other.

To give the reader a feel for what is involved in each of these approaches, in the following paragraphs the main issues and hypotheses are identified. In Section 4 below we point out the complementarities between the two approaches and in Section 5 their relevance to development economics.

(a) *Transaction and information costs*

The first general approach is that of "transaction costs" and "information costs," which contains several different but interrelated themes.[4] One such theme is concerned with the role of transaction costs in economic organization. It has been stimulated by the influential work of Oliver Williamson (1975, 1979, 1985) who has combined the concepts of bounded rationality and opportunistic behavior. The general hypothesis is that institutions are transaction cost-minimizing arrangements which may change and evolve with changes in the nature and sources of transaction costs and the means for minimizing them.[5]

A second theme is the property rights approach which is associated with the law and economics literature. Based on the pioneering work of Alchian (1959, 1961), Coase (1960) and Demsetz (1967), this approach explains how technological and other conditions including apparent externalities can give rise to the kinds of institutional mechanisms for internalizing externalities known as property rights. The existence of property rights may reduce conflicts and facilitate cooperation, in both cases resulting in a reduction in transaction costs. In this way, along with technology and other traditional constraints, institutional constraints enter into the decision processes of individuals. In the presence of transaction costs, different systems of property rights yield solutions of differing efficiency. What is efficient in the presence of transaction costs may be quite different from that which is efficient in the traditional neoclassical economics without transaction costs. As such, the property rights approach is closely related to that dealing with transaction costs and their role in determining both the form of organization of firms and the relative importance of the market, on the one hand, and hierarchical authority, on the other. A key proposition in the property rights approach associated with Coase (1960) is that, in the absence of transaction costs at least, the assignment of property rights would lead to efficient contractual outcomes through bargaining and negotiation. However, as has been stressed by Farrell (1987), the proposition is valid only when all the relevant information is public knowledge. When this is not the case, efficient outcomes are no longer guaranteed and the outcome of bargaining may be inefficient.

This leads to a third theme which is concerned with incomplete information and asymmetries in information in particular. While this theme has developed quite separately from the first, and the analysis to which it has given rise is more

mathematically oriented, the two themes are intimately related. Indeed, information problems can be considered as one particular source of transaction costs.[6] The problems of "adverse selection" and "moral hazard," which were first identified in the context of insurance markets, have been found to be relevant for a large class of problems where asymmetries of information are present between the parties to a contract. These problems, moreover, may lead to "market failure" unless incentive mechanisms capable of overcoming them, such as appropriate forms of contract, are developed.[7]

It should be clear, therefore, that asymmetries of information are closely related to opportunistic behavior and transaction costs. When the information set available to one party to a contract involving two parties is not identical to that available to the other party, one of the parties may be able to engage in opportunistic behavior so as to increase that party's benefits at the expense of the other's. However, the latter may engage in monitoring or information search activities in order to minimize his(her) loss. These activities, however, are costly and have to be matched with their expected benefits.

Both the economics of transaction costs and that of costly information have recognized the existence of a general "agency problem" in contractual arrangements. Jensen and Meckling (1976) and Williamson (1975, 1985) have applied the agency concept to managerial behavior and the ownership structure of firms. Moreover, it can readily be generalized so as to be applied to any situation where contracts are incomplete and/or information is asymmetric and the action of one individual, the "agent," affects another individual, the "principal." Problems in corporate management, labor markets, government procurement, insurance and credit contracts can be analyzed using the agency framework.

The general approach of "transaction and information cost economics" has proved to be particularly useful for the analysis of contractual choice. One such area of application is that dealing with contracts between different owners of the inputs used in production. If all economic agents were equally well endowed in the resources relevant to productive activities, and there were no economies of scale, production could very conceivably take place without recourse to contracts among the owners of the productive inputs. Every individual would constitute a Robinson Crusoe-type economy. However, since economic resources are not distributed in this way and scale and specialization economies are frequently important, there is almost inevitably a need for contractual relationships. Those agents relatively better endowed in some resources, such as land and capital, can contract to sell some of these resources to those agents better endowed in other respects, such as labor, human capital and experience, and/or to buy from the latter.

Regardless of the specific nature of the economic activity in which the different productive inputs are combined, the forms of contract virtually always turn out to be one or another variant or mix of the following: (a) fixed rent contracts, (b) wage contracts, and (c) share contracts. While this nomenclature is appropriate only for contracts involving exchanges among the owners of inputs into the production process, there are parallels with regard to contractual relationships involving exchange of the outputs within the production process. For example, when the producing firm is forward-integrated into retail markets, and hires its own marketing people, it uses a wage contract. Likewise, when the producer sells directly to separate retailers, this is the counterpart to a fixed rent contract. Finally, if the producer does not sell to the retailer but rather the retailer sells on behalf of the producer on a consignment basis, this is the counterpart to a share contract. Important opportunities to test hypotheses about the determinants of such contractual mixes arise because these contractual mixes vary over both time and space.

Another area of application concerns the identification of the factors affecting the relative importance of market and nonmarket activities and institutions in the course of economic development. What factors distinguish what is done via "arm's-length" market transactions between households and firms, or among different firms, from what is done within households, on the one hand, or within vertically or horizontally integrated firms, on the other? How do these factors change with modernization and development?

In this respect, social scientists have over the years offered numerous different explanations for the rise of the market. Particularly rich in insights has been the work of Williamson (1975, 1985) emphasizing the role of efficiency tradeoffs between the economies of specialization and market transactions, on the one hand, and those of intrafirm coordination and control or hierarchy, on the other hand. While both market transactions and internal hierarchy involve transaction costs, according to Williamson the choice between them depends largely on their relative magnitudes.

(b) *Collective action*

The second general approach in the NIE, and

which is therefore distinct from either the transaction or information cost approaches, concerns collective action and the elimination of "the free-rider problem." The key issue in the collective action literature is to "explain collective outcomes in terms of individual motivation" (Hardin, 1982, p. 2), or, to put it differently, to explain the likelihood of success or failure of a given set of self-interested individuals in undertaking actions that may benefit them collectively.

The theory of collective action has been concerned with public or collective goods not only of physical character, such as pollution, highways, parks and the like, but also and more interestingly of an abstract character, such as a higher wage rate, a higher price, a tariff or quota, a regulation, a lower tax rate or a policy rule. The public or collective goods aspect of collective action gives rise to the free-rider problem inasmuch as the self-interested individuals may find it preferable *not* to participate in the provision of the public good and/or to reveal false preferences about its value to them. This problem derives from two characteristics inherent in public goods, namely that, once the goods are provided, individuals can no longer be excluded from their benefits and that their value to existing beneficiaries is not reduced by increasing the number of beneficiaries. The incentive to free ride analyzed by Olson (1965), Hardin (1968) and others tends to result in inefficient collective outcomes in that public goods are underprovided. The theory of collective action has been concerned not only with the explanations for how optimizing behavior on the part of individuals can result in noncooperation but also with the identification of conditions under which cooperation can be achieved. An extensive literature — theoretical, empirical, and experimental — has evolved, showing that cooperative outcomes in which the free-rider problem is overcome can be and actually are reached.

One segment of this literature, namely that concerning the emergence of behavioral norms and rules (Ullman-Margalit, 1977; Schotter, 1981; Brennan and Buchanan, 1985), has remained almost entirely theoretical. In the case of the emergence of interest groups and organizations, however, the theory of collective action has gone well beyond the realm of pure theory. This work has been spearheaded by the publication of two remarkable books by Mancur Olson (Olson, 1965, 1982), and a synthesis by Hardin (1982). In Olson's analysis considerable attention in the explanation of success in collective action is given to the nature of the group, such as its size, its age and its purpose, and the extent to which group characteristics are shared among group members, such as homogeneity in origin and in goals, and the role of selective incentives in the realization of collective action and the overcoming of free-rider problems. Such incentives may take the form of positive "joint product" benefits to members who participate in group activities or of penalties imposed on those who fail to contribute to the collective action.

In addition to the group characteristics emphasized by Olson and his followers, a number of other factors have been identified that are likely to enhance the prospects for collective action. The availability of political entrepreneurs (Hardin, 1982) and psychological attitudes such as relative deprivation among group members (Brenner, 1983) can explain why certain groups become organized even if on the basis of Olson's group characteristics they would appear to be weak. Success in collective action may also be affected by the tolerance on the part of other groups, and by the quality of communication and organizational skills and the knowledge of the technology of collective action among group members and particularly among the leadership. Also the concepts of "exit" and "voice" provided by Hirschman (1970) are useful not only in distinguishing between success and failure in collective action but also in identifying the nature of any collective action taken. Specifically, the members of any organization or group who may be dissatisfied with the functioning or performance of the organization or group have two choices, namely, to remain in the group but to express their dissatisfaction through "voice," e.g., by criticizing the group and trying to reform it by taking political action within it, or to "exit," i.e., to leave the organization or group. When the latter is relatively costless, exit is likely to be chosen over voice, thereby undermining the possibilities of collective action.

Another major field of investigation in the theory and application of collective action concerns the use of a common pool of resources and the so-called tragedy of the commons that frequently arises in such cases (G. Hardin, 1968). In this type of problem, the public or collective goods considered are subject to a significant degree of congestion. The principles of collective action seem to imply that the joint use of common-pool resources, such as bodies of water, pools of oil, grazing land, parks or fishing areas, is likely to be problematic, at least in the absence of a system of individual property rights. This is because each user would have the incentive to

overuse the resource, eventually leading to its depletion and destruction.

As a result, policy prescriptions usually emphasize the need for the external imposition of a system of private property rights or the strict enforcement of rules designed to avoid the problems of communal ownership by an external authority such as the government. However, recent studies by Erickson-Blomquist and Ostrom (1984), Ostrom (1986), Runge (1981, 1986) and Wade (1987) have shown that special institutional arrangements including customs and social conventions designed to induce cooperative solutions can overcome the collective action difficulties and help achieve efficiency in the use of such resources.

The relationship between interest groups and the state is also receiving increasing attention in the collective action literature. When the state can be considered as playing only a mediating role in collective action, passively responding to interest group pressures, the various principles discussed above can be used to assess the relative influence of different groups over policy. Frequently, however, the state and its agents are not merely neutral and passive bystanders in the process of group interaction. This has given rise to the positive theory of rent seeking which is concerned with the means that interest groups use for getting what they want, i.e., by affecting voting patterns, legislation and regulatory agencies, administrative budgets, rules and/or judicial decisions.[8] Empirical applications of rent seeking include the determination of trade protection and of income transfers to farmers. The normative theory of rent seeking, however, suggests the importance not only of the costs of creating new institutions but also of the distinctions both between profit seeking and rent seeking and between competitive and noncompetitive rent seeking.[9]

Since the theory of rent seeking has been developed and applied mostly to developed countries (DCs) within an institutional framework of representative government but LDCs are generally characterized by autocratic governments and bureaucracies, this raises the question of the extent to which the theory and its predictions can be transferred to LDCs.

While most of the aforementioned elements of collective action theory are essentially static in character, in the last few years collective action theory has become more concerned with dynamic issues which are of major relevance to institutional change in general and development in particular. These considerations will be discussed below.

4. COMPLEMENTARITIES BETWEEN TRANSACTION COSTS AND COLLECTIVE ACTION

While the two main branches of the NIE identified here, namely, the analysis of transaction costs, information costs and contractual choices, on the one hand, and the analysis of collective action and pressure groups, on the other hand, have developed quite separately, they are by no means independent or unrelated. In fact, many issues and approaches in the NIE are at the confluence of these two approaches, thereby constituting interesting subjects for further study, and justifying their joint treatment.

First, there are important similarities in the frameworks themselves and the axioms upon which they are based. For example, as in the analysis of transaction costs, collective action is analyzed from the point of view of self-interest and bounded rationality, including opportunism.

Second, both transaction costs and collective action may be affected by the same factors. For example, caste, ethnicity and family loyalty may affect the contractual relations among members of an economic organization by reducing transaction costs (Ben Porath, 1980; Pollak, 1985; Nugent, 1985), but also may either facilitate collective action by their members by helping to solve the free-rider problems which plague or retard such action by increasing the transaction costs of change (Akerlof, 1976; Basu, 1986; Basu, Jones and Schlicht, 1987). Both transaction costs and the likelihood of collective action may also be affected by changes in commodity and factor prices, risk and expectations.

Third, because the role of government is emphasized in both the transaction cost and collective action components of NIE, they have to be interrelated and complementary. On the one hand, government decisions affect the transaction and information costs of the different economic agents and thereby their choices of organizational form and type of contract. On the other hand, the different agents or groups have the incentive to organize themselves in such a way as to influence these government decisions in the protection of their interests.

Fourth, since governments as a whole or the branches thereof (legislatures, ministries or public enterprises) are also organizations plagued with internal sources of inefficiency arising from transaction and information costs, these objects of collective action are at the same time subject to transaction and information costs.[10]

Fifth, even when voluntary, actual contractual choices are typically made within contexts in which various other institutions or "macro rules" are given. Among the given institutions are the systems of property rights and "transaction rights,"[11] the family (and the complex set of reciprocal responsibilities that family participation entails), other social norms and conventions, community bonds, ethnicities, local and national laws and regulations, and the judicial and penal systems. The existence of norms and conventions facilitates coordination and cooperation and protects expectations. In some cases, certain changes in these macro rules can significantly reduce transaction costs and thereby stimulate economic development, but not essentially unambiguously.

When any individual or group finds that, at least from his (its) own perspective, the existing contractual alternatives, macro rules, or other institutions are inefficient, inequitable or both, that individual or group is a potential candidate for engaging in collective action to change the contracts, macro rules or both in such a way as to improve the outcome for himself (itself).

Since in this sense collective action can be said to begin where contractual choices based on the principles of transaction costs leave off, the two perspectives are obviously complementary. Both have a lot to do with explaining institutions and changes therein. Moreover, one approach may provide a solution to the problem of the other. For example, if existing contracts are inefficient, collective action to initiate a change may be the solution. Likewise, one means of attaining collective action, and hence of solving the free-rider problem inherent in it, may be a contractual one designed to overcome free riding.

One hypothesis that may be advanced in the light of this dynamic interaction is that the transaction cost analysis of existing contractual arrangements is relevant when such costs are not so prohibitive as to prevent their formation. But when the costs of transacting are very high, strategic behavior becomes rampant and collective action becomes necessary in order to find a solution. Similarly, the two approaches may be used simultaneously in order to explain some dynamic institutional interactions. For instance, the formation, functioning and evolution of some organizations may be fruitfully analyzed in terms of both transaction costs and collective action. Hence, the relative position, power and composition of subgroups in an organization may be explained in terms of collective action theory, but then the determination of the structure of authority within it may be fruitfully analyzed in terms of transaction costs. Inversely, the internal structure and the costs of organization may affect the relative position of the subgroups.[12]

The X-efficiency theory of Leibenstein (1966) provides another example of potential complementarity between transaction costs and collective action principles. Leibenstein hypothesizes that firms and other nonmarket organizations fail to use the resources available to them as efficiently or as fully as they could and identifies some of the factors responsible for this. De Alessi (1983) shows how the basic postulates and axioms of the X-efficiency theory are rooted in transaction cost considerations. In particular, the postulates of selective rationality, the existence of inert areas, and incomplete contracts, which imply that effort is a discretionary variable, can be interpreted as following from rational choice in the presence of transaction costs. Moreover, Leibenstein (1986) shows how a major facet of X-efficiency theory, the less-than-maximum effort by the individual agents, can be understood to arise because of free-rider and collective action problems.

In general, therefore, it would seem highly desirable that the two approaches be brought together so as to allow the analyst the opportunity to take advantage of their complementarities.

5. THE NIE AND DEVELOPMENT

With the exceptions noted above (and in more detail in Nabli and Nugent, forthcoming, most of which are confined to agriculture), the dearth of systematic attempts to apply the potentially useful NIE approach to development has already been noted. In the remainder of the paper we deem it important to identify some major areas of potential use of the NIE in the context of development.

It has long been recognized that traditional neoclassical economics, by taking institutions as given or failing to recognize their relevance for the analysis of economic problems, has been unable to provide satisfactory explanations for a wide range of conditions commonly found in LDCs. For example, neither general references to market imperfections and distortions nor detailed analyses of their welfare consequences help explain either the pervasiveness of these imperfections and distortions or the considerable difficulties in removing them.

Marxists and neo-Marxists, of course, have been quick to fault neoclassical economics for these failures and have asserted their own explanations based on class relations which in turn depend on the relations of production. Frequently also, they criticize these existing institutions

for their coercive character and their impeding effects on development and distribution. Some common examples that have been prominent in the development literature are sharecropping and the interlinking of credit and labor (credit of the labor-tying variety).[13]

Marxists have typically asserted these to be feudal, semifeudal or precapitalist in origin, and exploitative and regressive in effect. As Bardhan (1980, 1988, forthcoming) asserts, however, such authors have unfortunately overlooked various possible microeconomic explanations for these relationships.

Stiglitz (1985, 1986), Bardhan (1984a, 1988, forthcoming) and many other authors have shown how the economics of information and transaction costs can be useful in understanding these same institutions. Much of this work has been strictly theoretical in nature. The relatively rare empirical studies reviewed in Nabli and Nugent (forthcoming, Ch. 2) have involved cross-sectional comparisons among different individuals or groups at a single point in time rather than over time. As a result, they have generally been unable to separate the influence of transaction or information cost differences from those of cultural and other differences. Moreover, virtually no applications have been attempted in LDCs outside of agriculture.

Yet the potential applicability of transaction and information cost economics to issues outside of agriculture would seem great indeed. Indeed, such analysis seems very capable of explaining the greater importance of activities within households, ethnic groups, family enterprises and financially and vertically interrelated groups and the greater degree of household extension in LDCs than in DCs. Likewise, and again as demonstrated in Nabli and Nugent (forthcoming, Chs. 2, 4–7), transaction cost considerations might well contribute greatly to explaining the choice of contracts among workers and employers, owners and managers in other sectors such as mining, fishing, manufacturing, transportation and tax collection. Such principles would also seem relevant in guiding reforms in LDCs like China desirous of undertaking serious reforms.

As explained above, one of the purposes of this study is to evaluate the extent to which the various approaches utilized are applicable to the rather differing conditions of an LDC. The absence or underdevelopment of various markets, such as those for finance, insurance and future transactions of commodities, skilled workers and managers, is itself a subject of interest that may be analyzed in institutional terms. Quite naturally, the degree to which well-developed and efficiently functioning markets of these sorts exist has a considerable effect on the reliability of information, the nature and extent of opportunistic behavior and the means of monitoring such behavior. In other words, the transaction costs of various market institutions have to be examined critically, since in LDCs their nature and magnitudes might well be very different from those in DCs, where the existence of such markets generally can be taken for granted. Moreover, the pervasive role of government in LDCs, itself an institutional feature demanding an explanation, should also be taken into account. By being party to contracts and being able to set rules and constraints, LDC governments can change the nature and role of transaction costs and information costs, either reducing their importance or magnifying them and thereby creating additional sources of opportunistic behavior.

While again Marxists and neo-Marxists have been quick to blame precapitalist, neocolonial or capitalist-controlled LDC governments for adopting policies inimical to social progress and equity in distribution, they have generally been unable to explain how this comes about. As shall be pointed out below, the theory of collective action is capable of explaining why the poor are frequently unable to organize themselves and hence likely to remain weak and poor. But, as Bardhan (1988) points out, this useful connection between the Marxian analysis of development policy and collective action has yet to be made.

Whether for this or other reasons, the numerous specific hypotheses inherited from the existing literature on collective action, which have been formulated and even in many cases tested on the basis of experience in DCs, have not yet been seriously investigated or empirically tested in LDCs.[14] Since the environmental conditions, including the channels of communication, the form of government, the focus of policy making, and the extent and nature of government regulation of economic activity in LDCs are quite different than in DCs, the determinants of interest group formation and the ability of different interest groups to overcome free-rider and other problems could be quite different. To what extent will analytical modifications be required in order to treat such issues in the LDC context? If modifications are necessary, how can they be characterized?

The principles of collective action seem applicable to a large number of problems, including the formation of labor unions (Olson, 1982), squatter communities (Hirschman, 1984; Jimenez, 1985), development projects (Hirschman, 1967), environmental groups (Hardin, 1982), and agricultural policies (Bates, 1981), the proliferation of

public enterprises, the survival of institutions which have outlived their usefulness, the urban bias of policies in LDCs, the rural bias of policies in DCs, and the delayed introduction of modern secular education (Nabli and Nugent, forthcoming).

Institutional change[15] can be considered to be at the heart of the long-run process of economic development, providing the missing link between development and growth. Although it is commonly stated that economic development can be defined as economic growth accompanied by structural change, it has proved difficult both to operationalize structural change and to identify its determinants and effects on development. Since institutions can be considered as part of this economic structure, an analysis of their determinants and effects may well constitute an important component of the relation between growth and development. Indeed, it might be appropriate to define economic development as economic growth accompanied by "efficient" institutional change. Numerous interrelationships between institutions and economic growth can be identified. On the one hand, economic growth can and frequently does trigger changes in institutions and, on the other hand, institutions can profoundly influence the level and rate of economic growth.

With respect to the effect of institutions on economic growth, the preceding discussion of the NIE shows that, by affecting transaction costs and coordination possibilities, institutions can have the effect of either facilitating or retarding economic growth. The choice of appropriate political institutions, rules and policies enhances economic growth. Moreover, by affecting resource mobility and the incentives for innovation and accumulation, institutions may induce or hinder economic efficiency in the allocation of resources and growth. Institutions affect growth also through their effects on expectations, social norms and preferences. Expectations are, of course, subjective, calling attention to the importance of perceptions and the way in which they are formed rather than only to the objective factors that are included in traditional economic analysis. Social norms can also play an important role in affecting the extent to which growth-enhancing activities can take place. For example, religious norms may either encourage or inhibit money lending and entrepreneurial activities. This calls attention to the role of preferences in institutional change and development. Enhancing some preferences or changing them may have an effect similar to that of setting norms or rules in helping to resolve free-rider problems and reducing transaction costs.

On the other hand, with respect to the effects of economic growth on institutions and, as noted above, running through all the principal themes of the NIE is the notion that economic growth may have profound impacts on institutions. Economic growth may well induce changes in contractual choices, the relative importance and character of markets, the extent of private property rights, the relative importance of different constraints, the relative position and power of interest groups and organizations, the relative importance of what is done within households and within firms (as opposed to the relations between them), technological choices (and hence the need for specific kinds of institutions), the costs and benefits of internal monitoring, and the degree of internationalization of the economy (and hence the degree to which any particular country's national authorities have the ability to enforce the relevant contracts and laws). Economic growth can render some existing institutions, such as norms, rules and policies, redundant and require others to come into existence.

Improved economic opportunities, in turn, may increase the mobility of workers, capitalists and merchants both geographically and sectorally. Greater mobility, however, may tend to undermine both the efficiency of the family, clan and community as sources of information with respect to trustworthiness, reliability, willingness to work and so on, and the effectiveness of such groups in exerting the kinds of positive and negative incentives that encourage the adherence to social norms. As confidence in the adherence to these norms and/or the reliability of expectations concerning anticipated behavior declines, this may require the development of new institutions for dealing with these issues such as new laws and regulations and a system of national justice, including the means of policing the laws and of imposing penalties on those transgressing the laws, and also new forms of insurance such as social security.

The dynamic interaction between institutions and economic growth poses the problem of institutional change and its relation to economic development, and in particular calls attention to the "efficiency of institutions."

Some practitioners of the NIE have assumed that competition — actual or potential — among alternative institutions would assure the emergence of efficient institutions at any point in time. As Matthews (1986) has pointed out, in such a case institutions are in continual and quick adaptation, and institutional change is a necessary concomitant of economic growth. If so, however, it would not be meaningful to consider

institutional change as an independent "determinant" of economic growth.

The opposing view considers that institutions may not always evolve "efficiently"; indeed institutional rigidities, inertia and so on may set in, thereby preventing, even for long periods of time, institutional adaptations to the various environmental changes and causing institutions to be inefficient. Citing a number of historical examples, Basu, Jones and Schlicht (1987) have suggested that it is quite possible that some institutional alternatives are eliminated from the feasible set by historical precedent, the forces exerted by existing institutions being one of the major forces impacting on the institutional choices of subsequent periods. Since efficient solutions may not be known, or even if known, may be ruled out by the idiosyncrasies of a given society's historical "endowment," there is no reason to believe that such an assumption of institutional efficiency is generally justified. Even if it were, its imposition would tend to make the analysis tautological, i.e., "what exists is efficient, therefore it exists."

Another reason for doubting that an existing institution is necessarily efficient is that its existence may be so much taken for granted that its efficiency and appropriateness go unquestioned and unchallenged. People may simply go on accepting the status quo without investigating its efficiency relative to that of the potential alternatives.[16]

Even if people should question the appropriateness of an institution, and indeed should realize its inefficiency, they may not have sufficient motivation to do anything about it. Akerlof (1976) and Basu, Jones and Schlicht (1987) cite the continued practice of the caste system and the excessive modesty and the abstinence from consumption displayed by Indian widows as examples. Institutions which benefit no one may be retained if each member of society fears being penalized (by ostracism or otherwise) for not adhering to the institutional rules. If institutional inertia can persist even when *no* member of society benefits from it, it should not be surprising that such inertia could frequently exist when only some members of society are disadvantaged by it. Even if the benefits of institutional change are known to be sufficiently large that, at least potentially, those who would benefit from it could compensate those who would be hurt by it, this does not mean that they will do so.

Another obstacle to institutional change is the difficulty of identifying and obtaining agreement on the best among the various possible means of accomplishing such compensation. The implementation of a compensation mechanism can be further impeded when such a mechanism conflicts with social convention. Naturally also, uncertainties about the magnitude of the potential benefits and costs and their distribution (which would be expected to be more substantial in LDCs) may further compound the problems by increasing the information and transaction costs of institutional change. Quite conceivably, frustrated groups may eventually be induced to resort to physical force either in promoting institutional change or in impeding it, quite possibly inducing violent counteraction by opposing group(s). All such actions would of course have the effect of further adding to the social costs of institutional change and lowering the likelihood that existing institutions would be efficient.

Explanations of the status quo and the failure of societies to adapt to changing circumstances has been given prominence in the "critical mass" models which feature interdependencies among the preferences of different individuals (Granovetter, 1978). Collective action in such analyses requires that a critical minimum or threshold number of individuals engage in it. Once the process is started, it feeds on itself through a bandwagon effect. The analysis can be generalized to introduce the phenomenon of preference falsification (Kuran, 1987) which may further amplify the process.

The propensity to adapt its institutions to fit changing circumstances quite naturally may vary from one society to another. Why and how? What are the factors that affect it? To what extent will economic growth be retarded by the inability to innovate institutionally? These are problems of the utmost importance in economic development and which are yet to be satisfactorily answered.

Of course, not all institutional changes are beneficial. Since, in the way we have defined them above, institutional changes involve substituting new constraints for old ones, the new ones may introduce distortions leading to static and dynamic efficiency losses. Additional social losses may be involved in the transition from one set of institutions to another, including the costs of designing and implementing the new institutions. Moreover, since a basic and valuable characteristic of institutions is predictability and the preservation of expectations, if such transitions are either too rapid or too frequent, they can undermine predictability and thereby impose social losses.

Since NIE explanations of existing institutional arrangements and their functions may well yield rather different policy implications than those derived from traditional approaches, the applica-

tion of the NIE to development policy could lead to significant new policy initiatives in LDCs. Stiglitz (1985) has illustrated this possibility with respect to policies for dealing with urban unemployment such as wage subsidies, unemployment compensation or shadow wage evaluation, and the design and extent of land reforms in rural areas of LDCs. These suggestions, however, have been made rather casually for illustrative purposes, not as serious propositions. Even taken altogether, the use that has been made of the NIE barely scratches the surface of its potential for development policy.

NOTES

1. For recent expositions of many of the elements of the NIE, the reader is referred to specialized journals like the *Journal of Economic Behavior and Organization*, the *Journal of Institutional and Theoretical Economics*, *Public Choice*, the *Journal of Law, Economics and Organization*, the *Journal of Law and Economics*, the *Journal of Economic Issues* and to several recent books: Mueller (1983), Eliasson (1986), and Langlois (1986a).

2. This is not meant to imply that there are as yet no attempts to explain institutions in LDCs. Indeed, the present conference, others at Indiana and Tilburg Universities and several widely scattered published contributions represent important attempts to overcome this lacuna. Most of these, however, deal with one particular element of NIE and are confined to a very few subjects such as sharecropping, caste, the choice of policy regimes, interlinking of markets and overgrazing. Several of the more scattered studies on rural institutions in India have been brought together by Bardhan (1984a, 1984b, forthcoming).

3. Note the absence of such a treatment in the most important textbooks in development. As a result, Basu (1984) and Hill (1986) criticize the theory of development in large part precisely for its failure to incorporate an institutional framework.

4. For instance, Matthews (1986) considers that the economics of institutions includes the following transaction cost-related themes: property rights, conventions, types of contract, and authority. See also North (1981, 1986a).

5. For some limitations on this hypothesis as well as a more complete discussion see Akerlof (1970, 1976), Basu (1984), Field (1981) and Dow (1987).

6. Stiglitz (1985) argues that information costs are a special case or form of transaction costs.

For some recent applications of relevance to agriculture and LDCs, see Akerlof (1970), and Greenwald and Glasspiegel (1983).

8. Among the important contributions by economists to these issues are those of Stigler (1971), Olson (1965, 1982), McCormick and Tollison (1981), Peltzmann (1976), Becker (1983) and Kalt and Zupan (1984).

9. See especially Krueger (1974), Buchanan, Tollison and Tullock (1980), Bhagwati (1982), Bhagwati and Srinivasan (1982), Tollison (1982), Colander (1984) and Appelbaum and Katz (1987).

10. Wolf (1986) calls attention to the parallel between "market failure" and "government failure." Crain, Leavens and Tollison (1986), on the other hand, call attention to the relevance and importance of transaction and information costs in the organization of government and the rules which it adopts in arriving at decisions.

11. See Blau (1964), Posner (1980), Witt (1987).

12. Indeed, such an analysis is applied to Tunisian labor unions in Nabli and Nugent (forthcoming, Ch. 11).

13. See, e.g., Bhaduri (1973, 1983).

14. Srinivasan (1985) has pointed out the relevance of these contributions to the study of economic development and in particular to trade policies.

15. Ruttan and Hayami (1984) present some elements of a theory of the determinants of institutional change and innovation as applied to agriculture.

16. See, e.g., the papers of Kuran, Bsaies and Azabou and Nugent in Nabli and Nugent (forthcoming, Chs. 6, 8 and 9).

REFERENCES

Adelman, Irma, and Thomas F. Head, "Promising developments for conceptualizing and modeling institutional change," Giannini Foundation Working Paper No. 259 (Berkeley, CA: 1983).

Adelman, Irma, and Cynthia Taft Morris, *Society, Politics and Economic Development* (Baltimore, MD: Johns Hopkins University Press, 1967).

Akerlof, George, "The economics of caste and of the rat race and other woeful tales," *Quarterly Journal of Economics*, Vol. 90 (1976), pp. 599–617.

Akerlof, George, "The market for lemons: Qualitative uncertainty and the market mechanism," *Quarterly Journal of Economics*, Vol. 84 (August 1970), pp. 488–500.

Alchian, A. A., "Some economics of property" (Santa Monica, CA: The Rand Corporation, 1961).

Alchian, A. A., "Private property and the relative cost of tenure," in Philip D. Bradley (Ed.), *The Public State in Union Power* (Charlottesville, VA: University of Virginia Press, 1959), pp. 350–371.

Appelbaum, E., and E. Katz, "Seeking rents by setting rents: The political economy of rent-seeking," *Economic Journal*, Vol. 97 (September 1987), pp. 685–699.

Bardhan, Pranab K., "Alternative approaches to the theory of institutions in economic development," in P. Bardhan (Ed.), *The Theory of Agrarian Institutions* (New York: Oxford University Press, forthcoming).

Bardhan, Pranab K., "Alternative approaches to development economics: An evaluation," in H. B. Chenery and T. N. Srinivasan (Eds.), *Handbook of Development Economics* (1988).

Bardhan, Pranab K., *Land, Labor and Rural Poverty: Essays in Development Economics* (New York: Columbia University Press, 1984a).

Bardhan, Pranab K., *The Political Economy of Development in India* (Oxford: Basil Blackwell, 1984b).

Bardhan, Pranab K., "Interlocking factor markets and agrarian development: A review of issues," *Oxford Economic Papers*, Vol. 32 (March 1980), pp. 82–95.

Basu, Kaushik, "Markets, power and social norms in a development context," Center for Advanced Study in International Development, Occasional Paper No. 9 (East Lansing, MI: Michigan State University, 1986).

Basu, Kaushik, *The Less Developed Economy: A Critique of Contemporary Theory* (Oxford: Basil Blackwell, 1984).

Basu, Kaushik, Eric Jones, and Ekkehart Schlicht, "The growth and decay of custom: The role of the new institutional economics in economic history," *Explorations in Economic History*, Vol. 24 (1987).

Bates, Robert M., *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies* (Berkeley, CA: University of California Press, 1981).

Becker, Gary S., "Competition among pressure groups for political influence," *Quaterly Journal of Economics*, Vol. 98 (August 1983), pp. 317–400.

Ben Porath, Y., "The F-Connection: Families, friends and firms and the organization of exchange," *Population and Development Review*, Vol. 6 (March 1980), pp. 1–30.

Bhaduri, Amit, *The Economic Structure of Backward Agriculture* (London: Academic Press, 1983).

Bhaduri, Amit, "A study in agricultural backwardness under semi-feudalism," *Economic Journal*, Vol. 83 (1973), pp. 120–137.

Bhagwati, J. N., "Directly unproductive profit-seeking (DUP) activities," *Journal of Political Economy*, Vol. 99, No. 5 (October 1982), pp. 988–1002.

Bhagwati, J. N., and T. N. Srinivasan, "The welfare consequences of directly unproductive profit-seeking (DUP) lobbying activities: Price versus quantity distortions," *Journal of International Economics*, Vol. 3, No. 1/2 (August 1982), pp. 33–44.

Blau, Peter M., *Exchange and Power in Social Life* (New York: John Wiley, 1964).

Brennan, Geoffrey, and James M. Buchanan, *The Reasons for Rules* (Cambridge: Cambridge University Press, 1985).

Brenner, Reuven, *History — The Human Gamble* (Chicago: University of Chicago Press, 1983).

Bruton, Henry J., "The search for a development economics," *World Development*, Vol. 13, No. 10/11 (1985), pp. 1099–1124.

Buchanan, James M., Robert D. Tollison, and Gordon Tullock (Eds.), *Toward a Theory of Rent-Seeking Society* (College Station, TX: Texas A&M University Press, 1980).

Coase, R. H., "The problem of social cost," *Journal of Law and Economics*, Vol. 3 (October 1960), pp. 1–44.

Colander, David C. (Ed.), *Neoclassical Political Economy: The Analysis of Rent-Seeking and DUP Activity* (Cambridge, MA: Ballinger, 1984).

Crain, W. Mark, Donald R. Leavens, and Robert D. Tollison, "Final voting in legislatures," *American Economic Review*, Vol. 76, No. 4 (September 1986), pp. 833–841.

De Alessi, L., "Property rights, transactions costs and X-Efficiency: An essay in economic theory," *American Economic Review*, Vol. 73, No. 1 (March 1983), pp. 64–81.

de Janvry, Alain, *The Agrarian Question and Reformism in Latin America* (Baltimore, MD: Johns Hopkins University Press, 1981).

Demetz, Harold, "Toward a theory of property rights," *American Economic Review*, Vol. 57 (May 1967), pp. 347–359.

Dow, Gregory K., "The function of authority in transaction cost economics," *Journal of Economic Behavior and Organization*, Vol. 8 (March 1987), pp. 13–38.

Eliasson, Gunnar (Ed.), *The Economics of Institutions and Markets* (Stockholm: Industrial Institute for Economic and Social Research, 1986).

Elster, Jon, *Making Sense of Marx* (London: Cambridge University Press, 1985).

Erickson-Blomquist, W. H. and Elinor Ostrom, "Institutional capacity and the resolution of a commons dilemma" (Bloomington, IN: Indiana University Workshop in Political Theory and Policy Analysis, 1984).

Farrell, Joseph, "Information and the Coase theorem," *Journal of Economic Perspectives*, Vol. 1, No. 2 (1987), pp. 113–130.

Field, Alexander James, "The problem with neoclassical institutional economics: A critique with special reference to the North/Thomas model of pre-1500 Europe," *Explorations in Economic History*, Vol. 18 (1981), pp. 174–198.

Gannagé, Elias, *Institutions et Développement* (Paris: Presses Universitaires de France, 1966).

Granovetter, Mark, "Threshold models of collective behavior," *American Journal of Sociology*, Vol. 83 (1978), pp. 1420–1443.

Greenwald, Bruce C., and Robert R. Glasspiegel, "Adverse selection in the market for slaves: New Orleans, 1830–1860," *Quarterly Journal of Economics*, Vol. 98 (August 1983), pp. 479–499.

Hardin, Garrett, "The tragedy of the commons," *Science*, Vol. 162 (December, 1968), pp. 1243–1248.

Hardin, Russell, *Collective Action* (Washington, DC: Resources for the Future, 1982).

Hill, Polly, *Development Economics on Trial* (London: Cambridge University Press, 1986).

Hirschman, Albert O., *Getting Ahead Collectively: Grassroots Experience in Latin America* (New York: Pergamon Press, 1984).

Hirschman, Albert O., *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Cambridge, MA: Harvard University Press, 1970).

Hirschman, Albert O., *Development Projects Observed* (Washington, DC: The Brookings Institution, 1967).

Jensen, Michael C., and William H. Meckling, "Theory of the firm: Managerial behavior, agency costs and ownership structure," *Journal of Financial Economics*, Vol. 3, No. 4 (October 1976), pp. 305–360.

Jimenez, Emanuel, "Urban squatting and community organization in developing countries," *Journal of Public Economics*, Vol. 27 (1985), pp. 62–69.

Jones, Eric, *The European Miracle: Environments, Economics and Geo-politics in the History of Europe and Asia* (Cambridge: Cambridge University Press, 1981).

Kalt, Joseph, and Mark Zupan, "Capture and ideology in the economic theory of politics," *American Economic Review*, Vol. 74 (June 1984), pp. 279–300.

Krueger, Anne O., "The political economy of the rent-seeking society," *American Economic Review*, Vol. 64 (June 1974), pp. 297–303.

Kuran, Timur, "Chameleon voters and public choice," *Public Choice*, Vol. 53 (1987), pp. 53–78.

Langlois, Richard N., "The new institutional economics: An introductory essay," in Richard N. Langlois (Ed.), *Economics as a Process: Essays in the New Institutional Economics* (New York: Cambridge University Press, 1986a).

Langlois, Richard N. (Ed.), *Economics as a Process: Essays in the New Institutional Economics* (New York: Cambridge University Press, 1986b).

Leibenstein, H., "Organizational economics and institutions as missing elements in economic development analysis," Paper prepared for the Conference on the Role of Institutions in Economics Development (Ithaca, NY: Cornell University, 1986).

Leibenstein, H., "Allocative efficiency vs. 'X-efficiency'," *American Economic Review*, Vol. 56 (June 1966), pp. 392–415.

Lewis, W. Arthur, "The state of development theory," *American Economic Review*, Vol. 74, No. 1 (March 1984), pp. 1–10.

Matthews, R. C. O., "The economics of institutions and the sources of growth," *Economic Journal*, Vol. 96 (December 1986), pp. 903–918.

McCormick, Robert E., and Robert D. Tollison, *Politicians, Legislation and the Economy: An Inquiry into the Interest Group Theory of Government* (Boston, MA: Martinus Nijhoff, 1981).

Morawetz, David, *Why the Emperor's New Clothes Are Not Made in Colombia* (New York: Oxford University Press, 1981).

Morris, Cynthia Taft, and Irma Adelman, "Economic development and institutional change in the 19th century," Paper presented to the Conference on Institutions and Development (Ithaca, NY: Cornell University Press, November 1986).

Mueller, Dennis C. (Ed.), *The Political Economy of Growth* (New Haven, CT: Yale University Press, 1983).

Myrdal, Gunnar, *Asian Drama: An Inquiry into the Poverty of Nations* (New York: Twentieth Century Fund, 1968).

Nabli, Mustapha K., and Jeffrey B. Nugent (Eds.), *The New Institutional Economics and Development: Theory and Applications to Tunisia* (Amsterdam: North-Holland, forthcoming).

Norgaard, Richard B., "Sociosystem and ecosystem coevolution in the Amazon," *Journal of Environmental Economics and Management*, Vol. 8 (1981), pp. 238–254.

North, Douglass C., "The new institutional economics," *Journal of Institutional and Theoretical Economics*, Vol. 142 (1986a), pp. 230–237.

North, Douglass C., "Institutions and economic growth: An historical introduction," Paper prepared for the Conference on the Role of Institutions in Economic Development (Ithaca, NY: Cornell University, 1986b).

North, Douglass C., *Structure and Change in Economic History* (New York: Norton, 1981).

Nugent, Jeffrey, B., "The old-age security motive for fertility," *Population and Development Review*, Vol. 11 (March 1985), pp. 75–97.

Offe, C. (Ed.), *Disorganized Capitalism, Contemporary Transformation of Work and Politics* (London: Cambridge University Press, 1985).

Olson, Mancur, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities* (New Haven, CT: Yale University Press, 1982).

Olson, Mancur, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1965).

Ostrom, Elinor, "Institutional arrangements for resolving the commons dilemma: Some contending approaches," in Vincent Ostrom, David Feeny, and Hartmut Picht (Eds.), *Rethinking Institutional Analysis and Development: Issues, Alternatives and Choices* (San Francisco, CA: The Institute for Contemporary Studies, 1988).

Ostrom, Elinor, "An agenda for the study of institutions," *Public Choice*, Vol. 48 (1986), pp. 3–25.

Ostrom, Vincent, David Feeny, and Hartmut Picht (Eds.), *Rethinking Institutional Analysis and Development: Issues, Alternatives and Choices* (San Francisco, CA: The Institute for Contemporary Studies, 1988).

Peltzman, Sam, "Toward a more general theory of regulation," *Journal of Law and Economics*, Vol. 2 (August 1976), pp. 211–240.

Pollak, Robert A., "A transaction costs approach to families and households," *Journal of Economic Literature*, Vol. 23 (June 1985), pp. 581–608.

Posner, Richard A., "A theory of primitive society with special reference to law," *Journal of Law and Economics*, Vol. 23 (April 1980), pp. 1–53.

Roemer, John, "Neoclassicism, Marxism and collective action," *Journal of Economic Issues*, Vol. 12 (1978), pp. 147–161.

Runge, Carlisle Ford, "Common property and collec-

tive ac
velopm
Runge,
nalities
traditi
Agricu
pp. 59
Ruttan,
induce
velopm
Schotter,
Institut
1981).
Schultz,
econon
Agricu
pp. 11
Scully, G
econon
nomy,
Srinivasa
state a
ment R
Stigler, G
Bell Jo
1971),
Stiglitz,
nomics,
pp. 25

tive action in economic development," *World Development*, Vol. 14 (June 1986), pp. 623–635.

Runge, Carlisle Ford, "Common property externalities: isolation, assurance and depletion in a traditional grazing context," *American Journal of Agricultural Economics*, Vol. 63 (November 1981), pp. 595–606.

Ruttan, V. M., and Y. Hayami, "Toward a theory of induced institutional innovation," *Journal of Development Studies*, Vol. 20 (July 1984), pp. 203–223.

Schotter, Andrew, *The Economic Theory of Social Institutions* (New York: Cambridge University Press, 1981).

Schultz, Theodore W., "Institutions and the rising economic value of man," *American Journal of Agricultural Economics*, Vol. 50 (December 1968), pp. 1113–1122.

Scully, Gerald W., "The institutional framework and economic development," *Journal of Political Economy*, vol. 96, No. 3 (1988), pp. 652–662.

Srinivasan, T. N., "Neoclassical political economy, the state and economic development," *Asian Development Review*, Vol. 3, No. 2 (1985), pp. 38–58.

Stigler, George, "The theory of economic regulation," *Bell Journal of Economics*, Vol. 2, No. 1 (Spring 1971), pp. 3–21.

Stiglitz, Joseph E., "The new development economics," *World Development*, Vol. 14, No. 2 (1986), pp. 257–265.

Stiglitz, Joseph E., "Economics of information and the theory of economic development," *Revista de Econometria* (1985).

Tollison, Robert D., "Rent-seeking: A survey," *Kyklos*, Vol. 35, Fasc. 4 (1982), pp. 575–602.

Ullman-Margalit, Edna, *The Emergence of Norms* (Oxford: Clarendon Press, 1977).

Uphoff, N., *Local Institutional Development* (West Hartford, CT: Kumarian Press, 1986).

Wade, Robert, "The management of common property resources: Finding a cooperative solution," *World Bank Research Observer*, Vol. 2 (July 1987), pp. 229–234

Williamson, Oliver E., *The Economics Institutions of Capitalism* (New York: Free Press, 1985).

Williamson, Oliver E., "Transaction-cost economics: The governance of contractual relations," *Journal of Law and Economics*, Vol. 22, No. 2 (October 1979), pp. 233–261.

Williamson, Oliver E., *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975).

Witt, Ulrich, "How transaction rights are shaped to channel innovativeness," *Zeitschrift für die Gesamte Staatswissenschaft* (1987), p. 143.

Wolf, Charles Jr., "Markets or governments: Choosing between imperfect alternatives," Rand Note No. 2505–SF (Santa Monica, CA: The Rand Corporation, 1986).

World Development, Vol. 17, No. 9, pp. 1349–1359, 1989.
Printed in Great Britain.

0305–750X/89 $3.00 + 0.00
Pergamon Press plc

Global Institutions for an Interdependent World

PAUL P. STREETEN
Boston University

Summary. — After a brief discussion of some necessary conditions for an international order concerned with development, a distinction is drawn, following Boulding, between the exchange system, the threat system and the integrative system. It pays one country to put up protectionist barriers, whether others do so or not; it pays one country to build up arms, whether others do so or not; it pays one country to pollute the global air and oceans, whether others do so or not. These typical prisoner's dilemma situations call for global reforms. There is a lag between technological advance that has unified the globe and the institution of the nation state. Suggestions are made as to how to overcome this lag, when the world no longer has a dominant power that provides the global public goods and avoids the global public bads.

1. INTRODUCTION AND SUMMARY

It has been said that the nation has become too small for the big things, and too big for the small things. In the course of growing national integration, the state has assumed more and more functions and responsibilities. To the nightwatchman's duty of maintaining law and order and enforcing contracts have been added such responsibilities as maintaining price stability, high levels of employment and high growth rates, population policy, regional policy, industrial policy, agricultural policy, responsibility for redistributing incomes and alleviating poverty through social services, protection of the environment, physical and human resource and energy policy, and others. As a result, some of these functions have not been carried out satisfactorily, while others have been neglected. The need for a greater degree of decentralization, delegation downwards, including delegation to market forces, and participation, is not the subject of this essay. It is part of the basic needs approach to development. But the need to delegate some functions upwards, to renounce some degree of national sovereignty in order to pursue national policies more effectively, is at the heart of this essay.

A major theme of this paper is that we are suffering from a lag of institutional adjustment behind technological advance. Technologically, the world has shrunk, but our social and political arrangements have not caught up with this advance. The result has been threats of mutual impoverishment and even mutual destruction.

In analyzing the direction of needed reforms, a distinction is drawn, following Boulding, between three systems: the exchange system, the threat system and the integrative or love system. The bulk of the economic development literature is concerned with the exchange system, in which transactions between North and South yield mutual benefits. Discussion of the threat system is largely confined to experts on military matters, but should also cover economic threats such as competitive protectionism, competitive devaluation, or investment wars. The integrative system, which calls for sacrifices by the North in the spirit of human solidarity, is not fashionable, but it is argued that without it little progress can be made. It embraces not only more and better development aid, but also changes in the rules, procedures and institutions that are now biased in favor of the North (such as cascading tariffs that discriminate against processing in developing countries, or discriminatory rules about immigration to the industrialized countries), and more "voice" in the councils of nations for the developing countries.

2. CAUSES OF THE DISORDER

In order to understand the present international economic disorder, it is useful to remember some of the functions that any international order for economic development must fulfill. There must be, first, a source for the generation of balance-of-payments surpluses. Second, there must be institutions that fulfill three financial functions: (1) institutions that convert these surpluses into long-term develop-

ment loans on commercial terms; (2) lenders of last resort to provide liquidity should confidence collapse; and (3) suppliers and withdrawers of international liquidity, according to the requirements of international trade and capital flows. There must be, third, the industrial and commercial capacity to produce, sell and deliver the capital goods needed for development. And there must be, fourth, military power to back the economic power, to see that contracts are enforced, property rights observed, and peace kept.

These four functions had been combined until about 1970 by a single dominant power, with the rest of the world dependent on the coordination by the center. Until 1914, this power was Great Britain, which established an international order and developed the areas of recent settlement in Canada, the United States, Australia, New Zealand, South Africa, and Latin America under the *Pax Britannica*. Current account surpluses were generated by Britain, the financial institutions grew in the City of London, gold or sterling provided the reserve currency for international monetary transactions, the industrial capacity of the north of England provided the iron, steel and capital goods, and the British navy kept world order.

There was not much of an order between the two world wars, but for a quarter of a century after the end of World War II, the *Pax Americana* established an international order centered on the mighty dollar. Current account surpluses originated from the United States, and for a time people worried about a chronic dollar shortage. New York became a rival center to London for financial transactions; the dollar replaced sterling as the world's reserve currency. Industrial capacity grew strong in the United States, and the American army enforced the American peace. But since 1970 these functions have been fragmented, split up between different centers, without coordination. For a period, the surpluses were generated by a few desert sheikhdoms in the Gulf, joined by West Germany and, most conspicuously and recently, by Japan. As the capital surpluses of the OPEC countries dwindled away and turned into deficits with the drop in the price of oil, West Germany and Japan continued to run surpluses. And $100 billion of surpluses were unaccounted for, presumably largely unrecorded capital flight from some of the developing, debtor countries.

The concentration in the financial centers of London and New York was diluted by the mushrooming of banks in Singapore, Hong Kong, Japan, Germany, and their affiliates in the Cayman Islands, the Bahamas and other tax havens. International liquid reserves were either too plentiful or too scarce and ill distributed, in spite of the creation of special drawing rights (SDRs). Industrial capacity increasingly shifted to West Germany and Japan, and to the newly industrializing countries. One of the most striking structural changes in the world economy has been the growth of manufacturing production and trade in an increasing number of developing countries. The military pygmies are the economic giants, whereas the military superpowers are economically weakened by their military expenditure. The four functions are dispersed among different groups of countries. The coordination arising from dominance by one country has been replaced by more or less successful forms of cooperation between countries with different degrees of power.

This breakup of uncoordinated functions provides us with the opportunity for a constructive institutional response. It allows for the replacement of the past international orders based on dominance and dependence, and on the needs of a superpower, by a pluralistic order of interdependence. International liquidity would be created according to global requirements of trade and capital flows, not according to the need to run deficits in the balance of payments of a capital-rich, reserve currency country. Financial institutions and multinational corporations would compete with one another on equal terms, and everyone would be free to buy in the cheapest and sell in the dearest markets. Many would say that such an order, even if it were desirable (which some doubt) would not be feasible. Richard Cooper has pointed out[1] that it took 50 years for international cooperation in such an obvious area as health to be achieved.

On the other hand, Robert Keohane has shown that it is easier to maintain international regimes than to bring them into being. Their continued momentum, after the power that has set them up has declined, depends on their economizing in transaction costs, on inertia, sunk costs and absence of alternatives. This explains to some extent the continued existence of the rules and procedures set up after the war even after American power has ebbed away.[2]

3. INTERDEPENDENCE

The period of postwar US dominance was one of comparative calm, economic expansion and commitment to development on the part of the rich countries. The retreat from Third World commitments started in the 1970s. The two oil shocks, the election of Mrs. Thatcher in Britain and Mr. Reagan in the United States, the turning

of attention to East-West issues abroad and to fighting inflation and unemployment at home, and the dominance of the international debt problem all contributed to this. At the same time, the old doctrinal wisdom on economic policy was overturned, partly as a result of internal theoretical strains. The emphasis shifted from fiscal to monetary policy, from demand management to supply management, from accelerator to interest rates as investment determinants, from public interventions to reliance on the private sector and market forces, and, somewhat earlier, from fixed to flexible exchange rates. In the same vein, there was a turn from concern for development to domestic issues.

Interdependence is often said to be large and to have increased. International trade is taken to be an indicator of interdependence, and its high, and, with some interruptions, growing values are accepted as evidence. Yet three important qualifications are necessary.

First, if we take the ratio of international trade to national income, the rapid growth in the postwar decades until 1976 can be taken to be a return to pre-1914 values. For the major countries, trade as a proportion of GNP has just about caught up with what it had been before the damage done by two world wars and the Great Depression. The ratio of exports to GNP was nearly 14% in 1960 and over 22% at the end of the 1970s, but it was about that before 1914.[3] If, however, we allow for the fact that the public sector has greatly increased, and that the prices of nontradable services in this sector have risen more than the average price level, trade as a ratio of private tradable goods has indeed increased since 1914 and continues to grow.

The second qualification is that few countries, or (in some cases) groups within countries, have participated in the benefits from growing trade, though their number has increased. The large, poor masses of the Indian subcontinent and of sub-Saharan Africa have not participated substantially in the growth of international trade.

The third qualification is that neither the volume of trade nor its rate of growth should be accepted as an indicator of economic interdependence, but rather the damage that would be done by its elimination, i.e., consumers' and producers' surpluses. Much trade is conducted in slightly differentiated consumer goods, which could readily be replaced by domestic production without great loss to consumers, judged by consumers' surpluses. This would have to be qualified only if the product differentiation were based on substantial economies of scale or yielded great benefits to consumers, so that the elimination of these lines and their replacement by domestic production would be very costly or would reduce consumers' satisfaction greatly.

There may even be an excess of international trade beyond the optimum indicated by trade theory because of cross-hauling at prices that are below total unit cost for foreign sales of, say, motor cars. On the other hand, small and slowly or not-at-all growing items of trade could be of very great importance and lead to substantial losses if they were eliminated. The United States, for instance, depends strongly on imports of manganese, tin and chromium.

Trade is, of course, only one, and not the most important, among many manifestations of economic interdependence. Others comprise the flow of factors of production, capital, enterprise and labor across frontiers; there is the exchange of assets, of legal rights, of information and knowledge. In addition to economic interdependence, there are educational and cultural, as well as military, strategic, and political impulses that are rapidly propagated throughout the world.

Sir Arthur Lewis, when he invited us to imagine that all the developed countries were to sink under the sea[4] suggested that, after a period of adjustment, the length of which would remain to be specified, it would not make much difference to the developing world. The same might be said about the developed countries, if the developing countries were to sink under the sea. Yet, with these qualifications, there is no doubt that interdependence has increased.

4. TECHNOLOGY AND INSTITUTIONS

There is a demonstrated gap between the rapid advances in technical knowledge, resulting in revolutions in transport, information and communications which have shrunk distances, on the one hand, and the political institution of the nation state, with its claim to sovereign authority and attempts to regulate the lives of its citizens and respond to their clamor for protection and insurance against the impact of interdependence on the other. It has been vividly symbolized by the shooting down of the Korean commercial airliner over Soviet territory, or by the Iranian revolution, or by the large sums of money moving across the world in response to instant information, and determining exchange and interest rates. As Stanley Hoffmann has said, the nation state has remained more obstinate than obsolete.[5] The tensions and contradictions created by this gap are at the root of the negative-sum games, the mutual infliction of damage in

an interdependent, though far from integrated, in some respects disintegrating, world.

The main conclusion I draw from what I have said so far is that we are suffering from a lag of institutional adaptation to the technological and political reality of the end of the 20th century. One institution, the nation state, is still rooted in a soil over 300 years old, going back to the Peace of Westphalia, while modern science and technology have moved ahead rapidly. The dispersal and fragmentation of the four development functions have meant that opportunities have been missed, and damage has been inflicted by the uncoordinated actions of these nation states.

I do not want to be misunderstood. When I speak of institutional innovation, I do not mean additional international bureaucracies. New bodies, organizations and forums have mushroomed. But international bureaucrats have often been an obstacle rather than a help to progress and reform, and have increased the resistance to change. Sir Herman Bondi has said that the stupidity of an organization is proportional to the cube of the number of its members. One can imagine the size of global institutions. What I have in mind by institutional innovation is rules, procedures and organizations that have precise technical functions (such as the successful Universal Postal Union), are immune from politicization, and are publicly accountable. I agree with viewing institutions "not simply as formal organizations with headquarters buildings and organized staffs, but more broadly as 'recognized patterns of practice around which expectations converge'" (Young, 1980, p. 337).[6]

It is worth noting that these institutional responses have occurred in the private sector. The multinational corporations, the Eurocurrency market and the transnational banks are responses to the revolution in information, communications, travel and transport. The equivalent in the public sector can be achieved, as is shown by some successful international bodies, such as the International Communication Union, the International Civil Aviation Organization, the World Meteorological Association, and a few others. We should aim at functional solutions at the global level.

Many of the problems in the international relations of interdependence arise from a combination of the free-rider problem, Olson's problem,[7] and the prisoner's dilemma. Indeed, the free-rider or contributor's dilemma is a special case of the prisoner's dilemma. The free-rider problem exists because some of the solutions of international difficulties consist in the provision of public goods.[8] A public good is one from whose supply all those who value the good benefit, irrespective of whether they have contributed to its costs. The concept can readily be extended to cover common goals or common interests, the achievement of which benefits all, irrespective of whether they have contributed to the costs of achieving these goals or interests. The enjoyment of the good or service by one person does not detract from the enjoyment of others. In this sense, international cooperation and the prevention of international wars are public goods. So are markets and a working international monetary order with an international central bank as a lender of last resort and as a provider of liquidity. Scientific research is of this kind. An international income tax or the coordination of international fixed investment decisions fall under the same heading.

These public goods will be, however, systematically undersupplied, because any one country will not find it worth its while to take the appropriate action, relying instead on others to do so; even though the benefits would exceed the costs were all to contribute. Each country, knowing that others will not act, has no incentive to be the only one to contribute to something that benefits others. As a result, international cooperation, peace, research, international monetary stability, and world development will be undersupplied. No one contributes and everyone is worse off. The Invisible Hand, which, according to Adam Smith, coordinates the independent decisions of a multitude of individuals, could also be applied and has been applied to the unintended coordination of the actions of nation states. But this Invisible Hand that is supposed to guide the self-interest of each agent, whether individual or country, to the common good, is not to be seen in the cases discussed above.[9]

It is true that free-rider problems are not ubiquitous. Individuals may be afraid of the sanctions attached to such behavior. Or they may avoid free riding because they believe that their contributions will make others contribute. Individuals sometimes do behave according to Kant's categorical imperative, in a manner that can be universalized. Otherwise why should anybody clap after a theater performance (assuming you don't get pleasure from clapping), or vote in a democratic election? But Kant's categorical imperative, or the notion that we should behave in the way we want others to behave, may apply less to the actions of nation states than to those of individuals. Leadership, and even hegemony, particularly by a strong superpower, and enlightened self-interest can contribute to such Kantian behavior by nation states.

The prisoner's dilemma arises because each country, in promoting its own national interest

rationally, contributes to a situation in which all countries are worse off. It pays any one country to put up protectionist barriers, whether others do so or not; it pays any one country to build up its arms, whether others do so or not; it pays any one country to pollute the common air and oceans, whether others do so or not. These are typical prisoner's dilemma situations, self-damaging and possibly self-destructive. Just as public goods are undersupplied, public bads are oversupplied. No single actor has an adequate incentive to remove them. This applies to competitive protectionism, beggar-my-neighbor devaluations or deflations, the spread of inflation, investment wars, the arms race, global pollution of the air and the sea, overfishing and excessive exploitation of exhaustible resources to which no property rights are attached, and similar situations. Richard Cooper has likened the situation to a crowd in which each member, wishing to see better a passing parade, rises to his tiptoes, with the result that no one sees better but everyone is more uncomfortable.[10] What is needed is either coordination and cooperation or supra-national sanctions that force all countries to act in what will amount to their self-interest. Without such coordinated or enforced action, the outcome of nationally rational actions will be irrational damage and mutual impoverishment. For the damaging action is the best, whether other nations act similarly or not

On the other hand, according to Coase's theorem, if, in the absence of transaction costs, and in the presence of a legal framework and full information, one country inflicts damages on another which are greater than the benefits to the first country, the injured country can enter into a contract and pay the injuring country to not inflict the injury, and be better off. Likewise, the injuring country can compensate the injured country for the damage, and still be better off. Such international compensations or bribes are in fact not common but they point, in principle, to the other extreme from that of the prisoner's dilemma. In such a world, Pareto optimal allocations would be achieved, for any deviation would give rise to joint gains, out of which losers could be compensated for accepting them.[11]

The difficulties of reaching Coase-type agreements and the dangers of ending in prisoner's dilemma situations are aggravated by four factors. First, there is no longer a hegemonic power, such as Britain before World War I, which is prepared to carry a large part of the cost of the public goods to exercise leadership to make others contribute. Second, the proliferation of independent nation states to about 160 makes agreements more difficult than in an age when fewer governments could establish a system of mutual trust or enforcement (Olson's problem). It is, however, true that most of these nations are quite small, and that coordination by a few large ones is what matters. Third, the rapid pace of social and technical change makes it more difficult to evolve the stability on which trust can be built. It has been shown that repeated games of prisoner's dilemma in similar situations tend to lead to cooperative solutions. Rapid change in the conditions on which cooperation is based prevents the formation of this kind of stability.[12] Fourth, the absence of world government and world courts makes it impossible to establish property rights, enforce contracts and set the sanctions for failing to abide by agreements.

As Michael Lipton has said,[13] if all outcomes were noncooperative prisoner's dilemmas, no government would be possible. If all were according to Coase's theorem, no government would be needed (except for income redistribution). The actual world is between the two extremes. But the relations of nation states are nearer the prisoner's dilemma end of the spectrum, for the four reasons given above.

5. THREE SYSTEMS

In order to set up a framework for a more constructive response to the call of the South for a better world order, Kenneth Boulding's distinction between the exchange system, the threat system and the integrative system is useful. The exchange system is based on the principle: "I do something good for you if you do something good for me." It covers the area of mutual interests. The threat system is based on the principle: "unless you do something good for me I shall do something horrid to you." In the integrative or love system, the principles of love and duty applied to ourselves and our family are extended to other members of a wider community. We do good neither in the expectation of good in return, nor under the threat of harm, but from a sense of unity or solidarity or duty. This sense can derive from a common ideology or from a sense of community and obligation. These not only reduce the danger of too many free riders, so that each contributes voluntarily to the common good that also benefits him, but also lead to some sacrifice for the benefit of others: genuine altruism. The three systems correspond roughly to positive-sum games, in which all participants benefit, avoiding negative-sum games, in which all would lose in the absence of coordinated action, and zero-sum games, in which one side

4?2

has to make concessions for the benefit of others.

Systems can, of course, be mixed. What appears to be a genuine sacrifice in the short run may turn out to be beneficial to the sacrificer in the long run. Or the removal of the benefit (such as access to markets) can constitute a threat. Or the division of the joint gains can give rise to conflicts. This, in practice, is a particularly important obstacle to the pursuit of positive-sum games. The gains come to be accepted and only the wrangles over their division remain.

It is important to distinguish between doing what is right, and wishing to be seen to be doing right because this is in the nation's self-interest. The United States is dedicated to a value system, what Myrdal called the American Creed. It adds cohesion to American society and strength to its foreign policy. But it is an entirely different thing to say, as a paragraph in the Kissinger Commission Report on Central America does, that it is in the American national self-interest *to be seen* to be acting right. "To preserve the moral authority of the United States. To be perceived by others as a nation that does what is right *because* it is right is one of this country's principal assets." There is all the difference in the world between doing what is right because it is right, and doing it because the United States must be seen to do what is right. It is in the US national interest to be seen to act in a moral way. The first action is moral, disinterested; the second self-interested.[14]

The distinction between the three systems is useful for a clear analysis, but not for negotiations. There we have an interest in pretending that what is truly a benefit to us is a sacrifice, so that we may get concessions on other fronts.

The exchange system of mutual interests has been much promoted, especially by the Brandt Commission, the OECD and the Overseas Development Council. Trade liberalization is the most frequently advocated policy. "Man was born free, but everywhere he is in chains." Similarly, all economists recommend free(r) trade, but everywhere there is protection.

It might be thought that, by and large, people, groups, and nations are very good in detecting and pursuing their self-interest and that not much exhortation is needed. But, as we have seen, there can be important divergencies between reaching for and achieving what is in one's interest. In some cases, the self-interested action leads to damage to oneself. We have already discussed the prisoner's dilemma and the free-rider problem. The first leads to the infliction of mutual harm, the second to the undersupply of public goods and the oversupply of public bads. In addition, the national interest may be damaged for several reasons. There can be conflict between groups with different power, articulateness, and influence, so that the more powerful influence policy more strongly, even if their gains are smaller than the losses of the less powerful, less articulate, less influential. Or there may be conflict between dispersed larger and concentrated smaller gains, or between uncertain larger and certain smaller gains, or between larger future and smaller present gains, or between perceived larger but really smaller gains. The last may be one of the reasons why the general public and policy makers are not prepared to surrender national sovereignty, even though its surrender would lead to a more effective achievement of self-interested objectives than the formal adherence to full sovereignty, autonomy and control, in the same way in which the acceptance of traffic regulations enlarges our freedom to drive accident free, while restricting our freedom of choice. Finally, the gains to some may be much larger than the gains to others, who, though gaining a little, resent this. In any case, the distribution of gains presents quite different problems at the international level from those at the national. For any national community, a central government can tax and redistribute gains if this is deemed desirable. But without a world government, this cannot be done at the international level.

In all these cases, selfish action may not lead to the achievement of self-interest, and the achievement of self-interested objectives may involve some sacrifice in unconstrained and uncoordinated selfishness. Moroever, it would be only a fluke if the actions dictated by national self-interest were to coincide with our development objectives, whether these are accelerated growth, growth with equity, redistribution with growth, or meeting basic needs. In particular, the poorest groups and the poorest countries will tend to be left out of a strategy based on national self-interest.

Removal of the dangers of the threat system and the avoidance of negative-sum games should have a high priority, for they can lead to mutual impoverishment and even destruction: disarmament, removal of the threat of protection, and an end to beggar-my-neighbor deflation or inflation, and of "voluntary" export restraints, are clearly lines of action worth pursuing. They call for international coordination and institutional responses of the kind discussed in this paper.

It may be thought that all agreements entered into voluntarily between states must amount to positive-sum games, in which each is better off. But this is not so. Some alliances may be formed with the specific purpose, or with the unintended

result, of inflicting costs on outsiders. In this case, alliances or pacts can lead to negative-sum games.

One of the reasons why agreements on avoiding negative-sum games, on reducing bads and creating anti-bads, are so difficult, is to be found in the logic of collective action, so well analyzed by Mancur Olson.[15] The larger the group, the weaker the incentive for any one member to contribute to the action that benefits all. We now have about 160 countries in the world. As a result, the public goods are not produced, or are underproduced, even though their value is greater than their costs to the group of countries as a whole. It is true that some smaller subset of countries, the Group of 5 or the Group of 7, may take responsibility for the rest, but they may also act in a way that imposes costs on others.

We can build on areas of common national interests, emphasizing mutual benefits to be derived from, e.g., resumption of orderly and equitable growth in the world economy, forswearing self-defeating protectionism, exploring ways of increasing the resources in globally scarce supply, etc. But while there is considerable scope for positive-sum games in exploring areas of common and mutual interests, and avoiding self-defeating, mutually destructive policies of the prisoner's dilemma type, there is also a "higher" interest in a world order that both is, and is seen to be, equitable, that is acceptable and therefore accepted, and that reduces conflict and confrontation.

All societies need for their self-regulation and for social control a basis of moral principles. Individuals are ready to make sacrifices for the communities in which they live. This forms the basis of the integrative system. Can this principle stop at the nation state? A belief in the harmony between self-interest and altruism is deep-seated in Anglo-Saxon thought and action. One is reminded of the 18th century bishop, Joseph Butler: "when we sit down in a cool hour, we can neither justify to ourselves this or any other pursuit, till we are convinced that it will be for our happiness . . . ."[16] The only question is why it appears to be easier to identify, or at least harmonize, individual happiness with the national interest than with that of the world community. It is odd that a moral, disinterested concern by rich countries with the development of the poor is hardly ever conceded. As hypocrisy is the tribute vice pays to virtue, so professions of national self-interest in the development of poor countries may be the tribute that virtue has to pay to vice.

In the present fashion of stressing common and mutual interests, we run the danger of underestimating the power of moral or humanitarian appeals. The Netherlands, Sweden and Norway, which have put international cooperation squarely on a moral basis, have hit the 0.7% aid target. It is the countries in which aid has been sold to the public as being in the national self-interest where the effort is lagging.

The common interests must also be defined in terms of different time horizons: the next year, the next five years, the next 20 years. There may be conflicts and tradeoffs between these different time spans. For example, concessionary aid to the poorest may involve economic sacrifices in the near future but, by laying the foundations for a world in which all human beings born can fully develop their potential, it contributes to the long-term interest of mankind

One difficulty is that in democracies adults have votes, but children and the unborn do not. The fight is not only against powerfully organized vested interests, but also against all our own short-term interests that neglect the interests of future generations.

Any attempt to build cooperation for development on moral principles has to answer three questions. First, do the rich in a community have an obligation in social justice (not only in charity) to the poor, and do the poor have a just claim on the rich? Second, does mankind constitute a community in the relevant sense, or do communities stop at national boundaries? Third, does the existence of national governments not interfere with the discharge of the obligations of the rich, if such obligations exist, to the poor in the world community, if there is such a community?

The first question cannot be answered without an analysis of various theories of moral philosophy. But both utilitarianism and various types of entitlement theory would provide a basis for an obligation of the rich to contribute to improving the lot of the poor in a community. Perhaps more difficult is the case for saying that mankind does constitute a community in the relevant sense. Social contract theories might say that we need not do anything for the world community because the world community does not do anything for us, whereas the state provides protection, security and certain other services. But even if the first two questions were answered in the affirmative, the third question presents the difficulty that the discharge of the obligation may take the form of what opponents of aid-giving have called "a redistribution of resources from the poor in rich countries to the rich in poor countries." To meet this difficulty we have to exercise our institutional imagination in finding procedures and institutions that avoid, or at least minimize, this possibility.

The "higher" interest in an acceptable world order can be defined either in moral terms or in terms of the desire to avoid negative-sum games, breakdown, and wars. Whatever the definition and justification, its aim is to transform adversary relationship into cooperation. When interests diverge or conflict, the task of statesmanship is to reconcile them This is a task quite distinct from, and more important than, that of exploring areas of common or mutual interest. It is in this light that cooperative action to eradicate world poverty and to restructure the international economic order has to be seen.

What, then, are the requirements of a sensible international order? It will consist of negative rules of what national governments must not do, and agreements on certain positive cooperative actions. The rules of abstention will be intended to prevent negative-sum games, and the rules of action to create some public goods and avoid public bads. Ralph Bryant has called these rules "supranational traffic regulations."[17] Some critics have accused the developing countries of wishing exemption from some general rules (such as reciprocity in tariff reductions or the banning of preferential trading arrangements) to which the developed countries should adhere. The discussion about appropriate rules for international economic relations has suffered from a long-standing confusion. It is the confusion between *uniform* (sometimes also called *general*) principles or rules (the opposite of specific ones, and therefore necessarily simple) and *universal* principles or rules (which may be highly specific and complicated, provided that they contain no uneliminable reference to individual cases). Further confusion is caused if a third characteristic of rules is added — *inflexibility* over time — and confused with either uniformity or universality. A rule is capable of being *altered*, though it remains either uniform (i.e., simple) or universal (i.e., may have a lot of "exceptions" written into it). The "equal" treatment of unequals is not a principle of justice, and a general rule commanding it is an unjust rule. In order to prevent partiality and partisanship, rules have to be universal, i.e., not contain references to individual cases. They may not, and indeed should not, be uniform. They should pay attention to the varying characteristics and circumstances of different countries.

Those who charge the developing countries with asking for exemptions from rules are guilty of this confusion between *uniform* and *universal*. Thus a differentiated system of multi-tier preferences according to the level of development of the exporting countries may be best and most just for a group of trading countries at different stages of development. A fair system of rules also points to the differentiation in responsibilities and rights according to circumstances. Middle-income countries would not have the responsibility to give aid, but neither would they receive it. They would not have to give trade preferences, but neither would they receive them. Even finer differentiation would be possible. A country with a large balance-of-payments surplus might be asked to contribute to loans because of its foreign exchange earnings, and, if its citizens enjoy high incomes, to aid because of its income per head, but might receive trade preferences if its level of industrialization is low. The 0.7% aid target would be replaced by a system in which those below a certain income per head are exempted, and the percentage target rises with income per head.

There is, of course, a practical and tactical case for *simple* rules, which might overrule the case in fairness for universal (though complex) rules: they are less open to abuse and easier to police. And there may be a tactical case for uniform rules; they may be easier to negotiate. It is for such pragmatic reasons rather than on theoretical grounds that one may advocate that rules should not be too complex, and should not be changed too often.

Any specific proposal, such as nonreciprocity in trade concessions, or trade preferences would, of course, have to be examined on its merits. But the distinction between "exemption from rules" and "drawing up new rules" is logically untenable, to the extent to which the call for exemption is really a call for a set of universal rules that pays attention to the different characteristics and circumstances of different countries, just as income tax allowances for dependents or lower rates on earned than on unearned income are not "exceptions" but reflect our notions of fairness.

Those who are concerned with changing the rules of international relations are aiming partly at removing biases in the present rules, and partly at the exercise of countervailing power where at present the distribution of power is felt to be unequal. They are also concerned with counteracting biases that arise not from rules but from the nature of economic processes, such as the cumulative nature of gains accruing to those who already have more resources, and the cumulative damage inflicted on those who have initially relatively little.

In so far as the call for new rules is about strictly economic relations, there is scope for positive-sum games. But in so far as it is about national power relations between sovereign states with different and conflicting aims, power is by its very nature a *relative* concept, and what

is at stake are *zero-sum games*. The demand by the developing countries for greater participation in the councils of the world and for corrections in the biases of the international power distribution are bound to diminish the power of the industrialized countries in conditions of conflict.

In addition to rules, there is a need for institutions. Let me give five illustrations of the kind of institutional reform I have in mind. First, there is the creation of an international central bank that would be able to create (and withdraw) international liquidity, both for transactions and for precautionary reasons. A panic run on the banks would cause an international financial breakdown unless an institutional arrangement existed that provided the liquidity. The General Arrangements to Borrow do this now to some extent, but a central bank would do this on a more solid and reliable basis.

The central bank would also be responsible for the growth of global reserves at a pace which gives neither an inflationary nor a deflationary bias to the world economy. In the absence of such a global authority, the competitive actions of nation states will tend to be either too restrictive, transmitting unemployment and unused industrial capacity, as each country scrambles to accumulate scarce reserves, or too expansionary, transmitting inflation throughout the world, as the reserve currency country incurs large balance-of-payments deficits to pay for economic or military ventures abroad.

Second, there is the institution of an international income tax. This could be levied progressively on GNP according to incomes per head, or, better, consumption per head so as to encourage saving, with a lower exemption limit. The tax would be collected automatically, but disbursed to developing countries according to agreed criteria. The monitoring of the fulfillment of the criteria should be done either by the developing countries themselves or by a mutually accepted transnational body.

Third, there is an international body to provide information on decisions for fixed, durable investment with long construction periods, so that we avoid the lurches from scarcity to excess capacity in steel, shipbuilding and fertilizers that we are suffering now. It should obviously not be a super-cartel that goes in for market-sharing agreements, but a method of coordinating investment decisions.

Fourth, there is an international investment trust that channels the surpluses of the surplus countries into a multilaterally guaranteed scheme to the developing countries. It would have guarantees against inflation and exchange rate losses for the lenders. The loans would be on commercial terms to middle-income countries. At the time of this writing, Japan has become the largest lending country, with a large surplus in its balance of payments on current account. This surplus is in search of good and safe investment opportunities, which calls for the creation of appropriate institutions to convert these surpluses into long-term loans to the developing countries. This would be in the interest of Japan, which could continue its export-led growth without having either to reduce its rate of savings or find domestic, lower-yielding alternatives; it would be in the interest of other OECD countries on whose exports some of the loans will be spent; it would be in the interest of the capital-hungry developing countries, whose resources are waiting to be mobilized by such capital flows; and it would be in the interest of the world economy which could maintain its expansionary momentum. An interest-subsidization scheme could be grafted onto this for the low-income countries.

If this argument is accepted, the general call for Japan to raise its level of consumption or divert investment to the domestic market is seen to be misplaced. Higher consumption should not be applauded in a world that is short of savings and in need of capital. Higher domestic Japanese investment is not desirable if it is subject to declining returns. Instead of calling on Japan to reflate, we should mobilize its excess savings and channel them on acceptable terms, by long-term lending or equity capital, through either the private or the public capital markets to the developing countries.

Finally, there should be a better way of dealing with the oil price problem than the erratic, zigzag movements that we have experienced since 1973. Oil producing and oil consuming countries should get together and agree on a small, annual increase in the real price of oil, say 2%. This assumes agreement on the best guess as to the real price of oil in 20 years' time. The balance-of-payments surpluses generated by such an increase could be channeled into the investment trust proposed above. The incentives to explore for more oil, find alternatives to oil, and increase conservation would be gradual but steady. The incentives for the oil exporting countries to use their revenue for investment in alternative productive assets would also be gradual and steady. Incentives to consumers of oil would also permit a foreseeable and gradual adaptation. There would be neither debt crises nor the sloshing around of large funds in search of remunerative and safe returns. And the world economy would be spared at least one major source of shocks and instability. Both inflation and unemployment rates would be reduced.

There is also a need for reforming the institutions charged with North-South cooperation. What has the Marshall Plan to teach us for current relations with the South? It is now generally agreed that the Marshall Plan loans to Europe were given on too soft terms, perhaps in too large amounts, but they achieved their objective of rapid European reconstruction. It has also become a platitude to say that the lessons are not applicable to the developing countries because in Europe the human capital existed, and to reconstruct with a skilled and well-motivated labor force is a much easier task than developing an underdeveloped society. But one important lesson can still be learned. Critics of both the left and right have pointed to numerous faults of aid; in particular that it has not achieved its intended objectives, whether they are poverty alleviation, redistribution or economic growth. They conclude that we should get rid of aid. A better conclusion might be to get rid of the faults and to evolve mechanisms that ensure that the objectives of the aid donors are achieved. The intervention of donor governments for the purpose of applying performance criteria to development aid has been regarded as inconsistent with national sovereignty, has been dismissed as intrusive, and has bred acrimony. It has also been difficult to separate objectives of accelerating development from objectives in the narrow national interest such as export promotion, gaining votes in the United Nations, forming political alliances or getting strategic support. Performance criteria imposed in bilateral relations by donor governments have therefore been suspect and counterproductive.

The task is then to evolve institutions that achieve the objectives of the donors and the recipients and are trusted by both sides. It is to resolve the dilemma between avoiding intrusiveness and paying respect to national sovereignty on the one hand, and responsible accounting for taxpayers' money on the other. Here the Marshall Plan has still something to teach. It is not about the speed of development, which for European reconstruction was faster than for the structural changes needed for development, nor about the terms of the aid, but about monitoring procedures. The European powers were encouraged to monitor one another's performance, and the heavy hand of the US government was kept out of it. Each government submitted a plan which was inspected, vetted and monitored by other European governments in the Organization for European Economic Cooperation (OEEC). Controls by peers rather than supervisors is also a principle advocated in business management. A similar procedure could be adopted for groups of developing countries.

There are at least two additional options. It would be desirable to create a genuine transnational secretariat whose loyalty would be only to the international community, that would be trusted by both donors and recipients. The staff of the present multilateral agencies does not quite achieve this, partly because the system of country quotas emphasizes national origins rather than merit, partly because the organizations are intergovernmental institutions, and partly because the recruitment, training, location, etc. of the staff of these organizations to some extent conflict with the ethos of a staff serving only the global community. In addition to having technical competence, the staff would be trained to be sensitive to social and political factors.

Finally, we might consider setting up a council of wise men and women whose task it would be to monitor the performance of both donors and recipients, and who again would be trusted by both sides. The existence of national governments that insist on the exercise of their full sovereignty at present interferes with the moral and enlightened self-interest objectives of development cooperation. Not until this obstacle is overcome can we make progress.

NOTES

1. Cooper (1985)

2. Keohane (1984), pp. 100–103. The key question discussed in the book *After Hegemony* is "how international cooperation can be maintained among the advanced capitalist states in the absence of American hegemony" (p. 43). From that point of view, the normative position taken in this paper is naively institutionalist, but the positive position is realist, for I believe that the postwar international regimes are best explained in terms of US hegemony. Nevertheless, Keohane comes to the same conclusion, viz., that continuing cooperation is possible if built on the interests of the leading capitalist states.

3. The ratio of exports to GNP for the United Kingdom was 19.3% in 1913, 20.7% in 1976, and 21.7% in 1984 (28.4% including services); for the United States, 6.5% in 1913, 6.8% in 1976, and 6% in 1984 (7.4% including services); and for Germany 20.5% in 1913, 22.3% in 1976, and 26.5% in 1984 (33.5% including services).

4. Lewis (1970), p. 12.

5. Hoffman, quoted in Keohane (1984), p. 238.

6. Keohane (1984), p. 8. The quotation is from Young (1980).

7. See below.

8. Kindleberger (1978), p. 15 and (1986).

9. Related problems have also been discussed under the concepts of "tragedy of the commons" (each agent, acting in his self-interest, contributes to social losses, such as overgrazing on a common pasture or overpopulating the globe), and "social traps" (no driver has an incentive to install a gadget that reduces pollution). These, as well as prisoner's dilemma, "collective action," and Olson's problem, are special instances of "market failure."

10. Cooper (1986), pp. 160–173.

11. Lipton (1985).

12. Axelrod (1984).

13. Lipton (1985).

14. The point is made and the quotation cited in Ash (1984).

15. Olson (1971).

16. Joseph Butler, *Sermons*, Sermon 11, para. 20.

17. Bryant (1980), p. 470.

REFERENCES

Ash, Timothy Garton, "Back yards," *New York Review of Books*, November 22, 1984.

Axelrod, R., *The Evolution of Cooperation* (New York: Basic Books, 1984)

Bryant, Ralph, *Money and Monetary Policy in Interdependent Nations* (Washington, DC: The Brookings Institution, 1980).

Cooper, Richard N., *The Economics of Interdependence: Economic Policy in the Atlantic Community* (New York: McGraw-Hill for the Council on Foreign Relations, 1986).

Cooper, Richard N., "International economic cooperation: Is it desirable: Is it likely?" *Bulletin of the American Academy of Arts and Sciences*, Vol. 39, No. 2 (November 1985).

Hoffman, Stanley, "Obstinate or obsolete? The fate of the nation-state and the case of Western Europe," *Daedalus*, Vol. 95 (Summer 1966), pp. 862–915.

Keohane, Robert O., *After Hegemony: Cooperation and Discord in the World Economy* (Princeton, NJ: Princeton University Press, 1984).

Kindleberger, C. P., "International public goods without international government," Presidential address to the 98th Meeting of the American Economic Association, December 29, 1985, New York, *American Economic Review*, Vol. 76, No. 1 (March 1986).

Kindleberger, C. P., *Government and International Trade, Essays in International Finance*, 129 (Princeton, NJ: Princeton University, 1978).

Lewis, W. Arthur, *The Development Process* (New York: United Nations, 1970).

Lipton, Michael, "Prisoners' dilemma and Coase's theorem: A case for democracy in less developed countries?" in R. C. O. Matthews (Ed.), *Economy and Democracy* (London: Macmillan, 1985).

Olson, Mancur, *The Logic of Collective Action*, 2nd edition (Cambridge, MA: Harvard University Press, 1971).

Young, Oran R., "International regimes: Problems of concept formation," *World Politics*, Vol. 32, No. 3 (April 1980), pp. 331–356.

World Development, Vol. 17, No. 9, pp. 1361–1373, 1989.
Printed in Great Britain.

0305–750X/89 $3.00 + 0.00
© 1989 Pergamon Press plc

Organizational Economics and Institutions as Missing Elements in Economic Development Analysis

HARVEY LEIBENSTEIN
Harvard University, Cambridge, Massachusetts

Summary. — The main objective of this paper is to apply X-efficiency theory to the analysis of organizations and state enterprises with special reference to developing countries. In particular, the black box relating to the internal operation of organizations is opened up to understand better the decision mechanisms operating within firms and institutions. Intrafirm conventions are explored as they relate to the impact of external and internal pressures on the decision-making process. Implications are drawn to improve the internal efficiency of institutions in developing countries.

1. OBJECTIVES OF THE PAPER

The main purpose of this paper is to make a plea for a certain type of research effort, in particular to argue in favor of including the analysis of economic organizations (whether private or state owned) as a critical element in economic development analysis. We will argue that the nature of the economic *organization* is a critical determinant of the results of development. Furthermore, institutional factors, from this viewpoint, can best be understood if we see how they impinge on organizational behavior. In the second half of this paper, we will present a brief version of X-efficiency theory, which emphasizes organizational behavior, and examine its implications for the internal efficiency of state-run enterprises.

Let us first consider the two systems of thought that dominate the teaching of economic development — standard macro theory and standard microeconomic analysis — and consider also what these systems have left out. What is included is an analysis primarily based upon flow variables. Microeconomics includes such flow variables as utility, costs, prices, quantities, all per period of time. In macroeconomics, the main variables are national income, consumption, savings, investment, profits, imports, exports, rates of population growth, etc., all as flows per period of time. Stocks are of limited importance. The formulation of the theories does not in any critical way require the concept of organization, or ideas about what goes on *inside* firms.

The main conclusion we draw from this is that theories and modes of analysis which are used by the majority of economists not only do not contain organizational concepts, but provide no incentive for theory inventors, elaborators or users to include organization ideas. It is not simply a matter that it might be awkward to fit in organizational variables; it is more likely that it does not enter the minds of economists in their normal work. The work itself does not seem to require that organization as a variable be faced or included in the models that are employed.

Now, consider the aspects of a developing economy that are left out. Our purpose is not to argue that there is anything wrong with normal modes of analysis, but simply to raise the question: Is something missing that might enhance our understanding? Consider the matter of investment. The standard approach is that investment may be a function of some aggregate such as income and the interest rate. The consequence of investment will be determined by some variable, such as a marginal capital output ratio. However, none of this asks anything about organizations. In other words, the questions are not raised: How are banks organized? Are they good at assessing who should and who should not get loans? In what firms will the investment be made? How are these firms organized? How does the nature of the organization of a firm deter-

mine the consequences of the investment? Nothing is said about economic behavior. Instead, functional relations of flow variables determine outcomes.

Part of the problem may reside in the fact that the enterprise in economic theory is a black box, as it were. We do not look inside. *How* decisions are made in terms of *details* and *procedures* is not part of the problem area of microeconomic theory. The theory is concerned with firm behavior and not with behavior *inside* the firm. To make the theory work, we indicate what the black box does by specifying its objective by such statements as maximizing profits, or maximizing a utility function containing such components as profits and growth.

Standard models of either the micro or macro variety can explain only a part of what goes on in the course of economic development. It is people, and especially people within organizations, that carry out decisions and put them into effect. It is, to a considerable degree, organizations' activities that determine development. An organization can produce at full capacity, at 50% of its ability, or at even less, depending on how effectively its members carry out their activities. For instance, there are organizations that carry out physical investment, or human resource investment with more success than others. A given amount of investment does not imply a given addition to national output.

Some of the estimates made by T. Y. Shen (1984) in an important article suggest how this applies to various developing countries. What is clear from Shen's work is that there is a very high degree of variation in inputs to get a given output, and this can only be explained by differences in organizational effectiveness in different countries. Thus, Shen's table suggests that how well organizations work is a major determinant of economic development. It is noteworthy that a less developed country will frequently use *both* more labor and more capital per unit of output than a more developed country.

Some basic questions come to mind. Can we improve our understanding of development by understanding how efficient economic organizations are in different countries? Do we have to think entirely in terms of increasing the resources available to a country, through loans, gifts, or other means, in order for a country to develop? Or, can we get equal or better results by analyzing the organizations involved, suggesting means for change, and changing the institutional environment under which such organizations operate? Clearly, I take the latter view.

The focus in what follows is on how organizations become internally inefficient, and why they remain so. This raises the idea that market inefficiency is not the entire problem, and that organizational inefficiency (X-inefficiency) may be more significant. Market-clearing prices may eliminate queues and apparent shortages, but they will not necessarily result in firms producing in an optimal fashion the products that enter the market. This suggests that markets are not everything in determining how well a country handles its economic activities, and that getting the prices right may enable us only to solve a part of the problem. Of course, there is an important relation between the nature of markets and the extent to which organizational inefficiencies are allowed to persist.

While firms are involved in markets, it is important to note that internal behavior of the firm does not depend, for the most part, on market circumstances. In other words, firms do not operate internally in terms of a competitive price system, quite the opposite. A considerable number of nonmarket interactions, of either an authoritarian or human-relations type, determine the behavior of firm members. Hence, to understand development we must understand the details of nonmarket behavior inside the organization, and the relation of such nonmarket behavior to the internal efficiency of the enterprise. If this approach is accepted then this clearly implies that standard microeconomics with its intense focus on market behavior, whatever its value at that level, cannot really enable us to understand economic development fully, where the productive behavior of large numbers of individuals is determined to a considerable extent by nonmarket considerations. Of course, there is a remote sense in which these nonmarket considerations are connected to markets, since firms purchase inputs in markets and sell their products in markets. It is important to understand, however, that any such influence on intrafirm behavior will vary with the exact degree of closeness or remoteness of individuals from market circumstances.

The next four sections on X-efficiency theory suggest the possibility of constructing a specific analytical model that can be used to assess the relative inefficiencies of different economic organizations. Readers should note that this suggestion is offered as a *complement* to existing tools used in economic development analysis. Note, also, at this point that the connection between the organizational analysis and institutions is through the concept of intrafirm conventions. Conventions, as used here, are essentially recognized ways of doing things within the firm, while institutions are conventions that go beyond the boundaries of the firm.

Table 1. *Comparisons of input productivities in physical terms**

Country	Per capita income (1970 US dollars)	Production input multiples Capital	Labor
Group 1			
1. United States (1966)	3,615	1.73	0.55
Group 2			
2. New Zealand (1968)	1,796	0.64	0.92
3. Norway (1963)	1,735	0.92	1.02
4. Venezuela (1971)	1,160	0.79	0.86
5. Japan (1966)	941	0.47	0.86
Group 3			
6. Singapore (1970)	916	0.68	2.21
7. Malta (1970)	689	0.93	2.90
8. Mexico (1970)	661	1.28	1.26
9. Costa Rica (1964)	419	1.09	1.68
10. Taiwan (1971)	418	0.81	2.07
Group 4			
11. Malaysia (1969)	325	1.08	2.31
12. Guatemala (1964)	324	1.27	2.18
13. Peru (1963)	268	1.80	1.57
14. Honduras (1966)	237	1.12	2.23
15. Ecuador (1965)	225	1.72	2.14
Group 5			
16. Pakistan (1964)	112	1.52	3.14
17. India (1966)	96	1.20	5.78
18. Nigeria (1965)	90	1.62	2.86

*"The results presented in Table 1 use two measures to compare the average plant in each sample country with its image plant on the Massachusetts expansion path. The "production input multiples" (PIMs) express the capital and labor inputs needed to produce one unit of output in a sample country as a percentage of the inputs employed in the image plant. The figures are unweighted averages of two-digit industry results. For example, the average plant in the average industry in New Zealand uses 64% of the labor input and 92% of the capital input of a comparable plant in Massachusetts" Shen (1984), p. 102.
Source: Taken from Shen (1984), p. 102.

2. A SCHEMATIC AND BRIEF VIEW OF THE ESSENTIALS OF X-EFFICIENCY THEORY[1]

The purpose of the next four sections of this paper is to present some aspects of X-efficiency theory and its application to the analysis of state enterprises. Our emphasis will be on the relationship between what we will refer to as environmental pressure and effort choice. Effort will be used as a very broad sense referring to any activity carried out by a human agent in a firm. After introducing other elements central to our theory we will then speculate about how these elements work themselves out in state enterprises.

Standard micro theory analyzes the activities that take place in markets, and makes very special assumptions about what takes place in nonmarkets. By nonmarkets we have in mind the activities that take place *within* households and *within* firms. Standard theory assumes that both households and firms operate in terms of certain maximizing *results*. Households are assumed to maximize utility, and firms are assumed to maximize profits. The pursuit of maximizing profits also implies the minimization of costs. With respect to intrafirm behavior, X-efficiency

theory focuses on the nonminimization of cost possibilities of firm behavior. This is the aspect we will be primarily concerned with in this paper.

X-inefficiency within the firm essentially means that the resources available to the firm are not utilized as well as they could be. The reasons for the particular degree of X-inefficiency may be due to some combination of historical, motivational, organizational structure, or inadequate "pressure" components. The essence of the model we have in mind can be seen in terms of the following five variable causative scheme:

$$E_i \rightarrow Pr_i \rightarrow Ch_i \rightarrow T_i \rightarrow C_i \qquad (1)$$

The variables are as follows: E_i represents environment i, Pr_i represents pressure, Ch_i represents choice, T_i represents a specific technique or "translation" of inputs into outputs, and C_i represents cost per unit of output. Thus the statement in (1) says that a given environment implies a certain amount of pressure, which in turn will imply a certain type of choice, especially choice of effort, which in its turn implies a certain "translation" of inputs into outputs, and this in turn implies a certain cost per unit.

We can readily see that all of this is very straightforward in the case of perfect competition. Let us use the subscript 0 (zero) for the perfect competition case. Thus, the set of implications are

$$E_0 \rightarrow Pr_0 \rightarrow Ch_0 \rightarrow T_0 \rightarrow C_0 \qquad (2)$$

E_0 is the perfect competition environment: there are many firms and each firm is small in relation to the market. This environment puts tremendous pressure on any individual firm. Here there is pressure for any particular firm to minimize costs. Otherwise competing firms will have lower costs, and competition among sellers will lead to a price that approximates minimum costs. This will also imply a choice for management to try to get everyone to put forth their most effective effort or else the firm will not survive. Thus the firm will use a cost-minimizing technique which in turn will imply a minimum cost per unit of C_0. Of course all of these assertions are well established on the basis of standard micro theory.

Now let us move to the opposite extreme: the environment E_i under which the firm is a monopoly. Clearly the monopolistic environment puts much less pressure on the owners of the firm or on the managers. Two questions come to mind: (1) what exactly is meant by "pressure," and (2) pressure to do what? For the time being let us assume that pressure is a reasonably meaningful term, and look at the second question. To begin with we may recall J. R. Hicks' famous quip that perhaps the greatest reward of the monopolist is a quiet life. Clearly, decision makers for monopolies do not face the pressure to make optimal decisions. Whether or not they in fact do make optimal decisions is another matter. At the very least they do not face the *external* or environmental pressures to make such decisions. They can make nonoptimal decisions and survive.

Environmental pressure may be viewed as being of two sorts: pressure from the "bottom" and pressure from the "top." Pressure from the bottom arises when buyers or users of the good have alternatives, and their availing themselves of the alternatives decreases gross revenue. Sellers in competitive markets obviously face a great deal of pressure from the bottom. They are forced to accept the competitive price, and if that is the only market in which they sell, they have to minimize unit costs if they are to survive. By pressure from the top we refer to pressures for performance from owners or owners' representatives such as a board of directors. In the case of state enterprises this would involve pressure from the government or its representatives — say the board of directors that the government appoints. Different institutional arrangements will involve different sources of pressure.

In contrast to conventional theory where costs are a well-defined function of output and other variables and parameters, F. A. Hayek (1945) has argued that costs have an inherent tendency to rise unless contained by management. Elsewhere I have attempted to illustrate this with the aid of Figure 1.

Under X-efficiency theory, there is a tendency for cost to rise and pressure is required to keep it down. It is not only that decision makers at the top may not be under pressure to make optimum decisions, but no one in the firm may be under pressure to allocate time to the application of effort so that costs are minimized. In general, pressure in some sense has to be transmitted from the top down through the system so that effort is applied as effectively as it can be in the interests of the objectives of the firm. The basic point is that if we assume that there is some degree of discretion available with respect to the use of effort everywhere in the firm, then it is possible that the effort will not be used most effectively without pressure. In some sense, pressure has to be felt at every point where discretion exists.

A useful intermediate case to consider is that of the profit-regulated private utility. Suppose there is a predetermined, legal maximum rate of profit. In that case profit maximizing is not

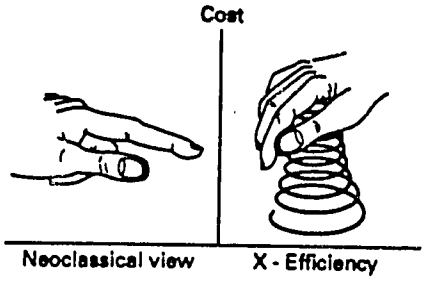


Figure 1. *Pressure under the neoclassical view and under X-efficiency.*

meaningful. The profit rate is given and there will exist a wide variety of price-cost combinations that will yield the same profit rate. Higher costs will permit the firm to charge higher prices and yield the same profits. Clearly in such a system there is no incentive to contain unit costs.

The essential choices that we will concentrate on are between effort and the particular technique of production. The standard theory is concerned only with *efficient* techniques. We look upon a technique as a particular combination of inputs. Thus, if to produce a particular output from two inputs α and β, we consider only two combinations, 6α and 6β versus 7α and 7β, in this case only the first technique (6α and 6β) is taken seriously in the standard theory. The second technique (7α and 7β) is inefficient because more of both inputs are utilized. The view we will take is that we want to consider both the efficient and inefficient techniques. In Figure 2, the area ABCD represents the set of techniques. The boundary DC contains only the efficient techniques. It is similar to the standard isoproduct curve. In our approach we assume that the techniques "chosen" are in general above the boundary CD. Of course, some techniques are close to the boundary while others are further away. But the boundary itself is approached as an asymptote. The degree of X-inefficiency for the ray 0R may be viewed as the ratio ER/0R. Thus standard theory visualizes choices being made on the boundary, while we look at them as taking place off the boundary. We may also visualize a set of choices on a quasi indifference curve above the boundary, where each choice represents an equal amount of X-inefficiency. These relations are illustrated by the curve IJ in Figure 2.

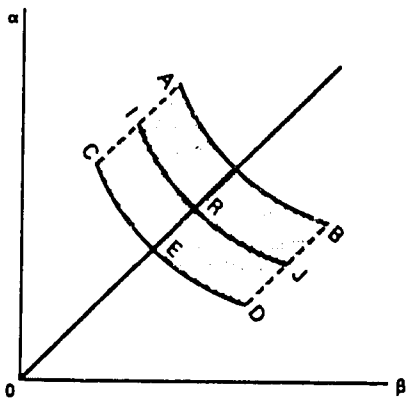


Figure 2. *Isoproduct curves for inputs α and β.*

A question we have to consider is to what extent the organizational system or part of the system operates as an effective cybernetic entity. In other words, is there a feedback arrangement between results and effort so that effort is increased when results are judged to be too low and decreased when judged to be too high? This will require that for various parts of the system there exists some *observable results* (OR) which reflect performance and which are transmitted directly or indirectly to some source of effort. Some possibilities of observable results are profits, costs per unit, productivity per worker, capital-labor ratio, deviation between actual and standard costs, or the deviation between the actual and some standard of performance. How well such a feedback mechanism works will depend on three aspects of the system: (1) the appropriateness of the observed results; (2) the effectiveness of the transmission to the effort source; and (3) the responsiveness of the effort source.

3. EFFORT AND THE CHOICE OF MECHANISM

In this section we turn to elaborate the theory of decision making that lies behind X-efficiency theory. The set of mechanisms we will outline includes maximization as a special case but considers the likelihood that most choices will not be of the type which approximates maximization. It may be best to describe the overall approach and then amplify the details. This can be readily done with the aid of Figure 3. In Figure 3, the X axis represents degrees of pressure and the Y axis represents the extent of the approach to maximization. Thus the Y axis represents a scale between zero and one so that one is maximization. For example, 7 would indicate a degree of effectiveness of decision making which is 70% of the maximization level. It is best to ignore for the time being the determination of the appropriate index of the extent of maximization. In what follows, we shall

substitute the term "complete calculation" for "maximization" since calculation describes a *procedure* we can readily apprehend.

In Figure 3 we see that the nature of the decision depends on the degree of pressure 0P. At low pressure levels decisions fall far short of the effectiveness of the completely calculated decision, while at some fairly high level the result approximates maximization. Also, the curve *Ca* indicates the possibility that at exceptionally high pressures individuals are no longer capable of carrying out completely calculated decisions and the degree of effectiveness falls thereafter. Of course, every individual will have a different type of decision-response function considerably above a relatively noncalculating individual. In any event, if we knew the response function and the degree of pressure in a particular situation, we would be able to assess the degree of calculatedness of the decision.

Herbert Simon (1978) has distinguished between *substantive rationality* versus *procedural rationality*. Economic theory involves a maximization assumption which should be interpreted as substantive rather than procedural. In other words, the theory does not indicate the procedures a person has to use in order to behave as a maximizer. Rather, the theory says that what the individual does *results* in maximization. An alternative approach is to study procedures as such. This is the approach that will be undertaken. We will specify certain procedures or processes (or categories into which they fit) and we will argue that some of these procedures involve nonmaximization although there is one which approximates maximization.

The procedures we have in mind fit into five categories: habits, conventions, work ethics, partial calculation, and full calculation. We assume that decisions are made in terms of a lexicographic ordering. An individual chooses within a category and shifts from one category to another as pressure increases sufficiently. In Figure 4 we draw a stylized decision function similar to the continuous one in Figure 3 above, such that as pressure increases there is a movement from one category to another toward procedures which come closer to complete calculation. However, for any given procedure there is a pressure range within which the procedure will not change. Thus in a particular case an individual on starting a new job may choose his or her effort level on the basis of the habitual pace used in previous employments. However, if some type of pressure from supervisors or fellow employees should indicate that this pace level is unacceptable, then the new worker would look around to determine what the convention is with respect to this work characteristic. He may then shift to the particular convention in force. We must recognize that there may be a variety of conventions that may be possible. If fact, a group of workers may, under some circumstances, shift from one convention to another.

In some cases a work ethic, the sense of what constitutes a fair day's work, may supersede a convention. If pressure should increase at some point, the individual might make a new decision based on partial calculation. Of course, there are degrees of partiality of calculation. From this viewpoint full calculation is the same as maximization.

4. THE INTERNAL PRISONER'S DILEMMA PROBLEM[2]

In this section we try to show that the relation between employee decisions and firm decisions can take the form of a prisoner's dilemma problem. We will show in the next section, however, that effort conventions and working condition conventions allow the latent adver-

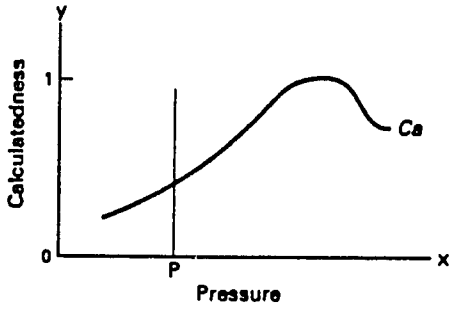


Figure 3. *Degree of calculatedness in decision making as a function of pressure.*

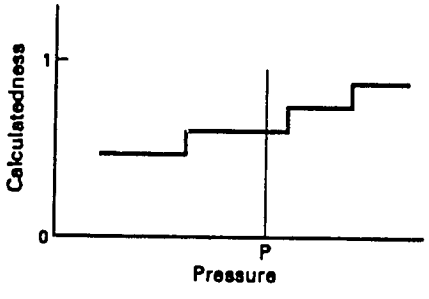


Figure 4. *Step-wise decision function.*

sarial
outcon
The
of mo
includi
wages
some n
which
differe
no on
motivat
employ
there is
This
on the
nonmax
manage
to get t
event, it
decision
cated ir
In Fi
options
these a
effort le
the firm
standara
mum an
forth
em
for
interests
can offer
maximiz
can acce
accordin
cost per
written i
tion. Em

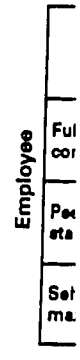


Figure 5.

sarial parties to avoid the prisoner's dilemma outcome.

The firm can offer its members a wide variety of monetary rewards and working conditions, including career opportunities. Every set of wages and working conditions contains within it some motivating force. Hence, there is a sense in which the firm may be said to choose among different motivating systems. However, there is *no* one-to-one correspondence between the motivating systems and the amount of effort that employees offer. For each motivating system there is a range of effort level responses possible.

This suggests the possibility of effort discretion on the part of firm members. At the same time, nonmaximization under low pressure implies that managers will not necessarily have the incentive to get the most out of their employees. In any event, it is clear that each side can make strategic decisions. The nature of such decisions is indicated in Figures 5 and 6.

In Figure 5 we show three basic strategic options available to each side. For employees these are: (1) *maximum commitment* (E_1), an effort level that involves the most they can do for the firm on a long-run basis; (2) *peer group standard* (E_2), an effort level below the maximum and similar to what other employees put forth; or (3) *selfish max* (E_3), under which the employee puts forth as much effort as possible for his or her *own* purposes rather than firm interests. The firm also has three strategies: (1) it can offer wages and working conditions (M_1) that *maximizes that benefit* to employees; (2) the firm can accept the *peer group standard* and pay accordingly (M_2); or (3) it can try to minimize the cost per effort unit (M_3). As the payoffs are written it is clearly a prisoner's dilemma situation. Employees will want to choose E_3 no matter what management chooses, and management will want to choose M_3 for every choice of the employees.

Employee \ Management	Full commitment M_1	Accept peer standard M_2	Minimum cost per worker M_3
Full commitment E_1	20 / 20	8 / 25	3 / 30
Peer standard E_2	25 / 8	10 / 10	4 / 15
Selfish max E_3	30 / 3	15 / 4	5 / 5

Figure 5. *Payoff of alternative strategies available to management and employees.*

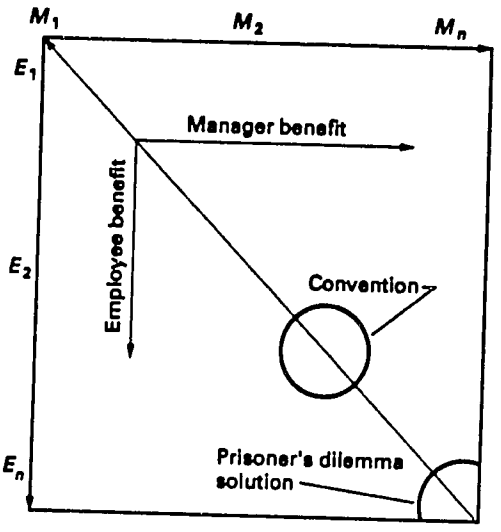


Figure 6. *Alternative management motivating options and employees' required efforts.*

Similar ideas are presented in Figure 6 for the case of $n \times n$ options. Assume each line is divided into n segments. The employer has n motivating options $M_1 \ldots\ldots, M_n$ such that $M_1 > M_2 \ldots\ldots > M_n$. This means that the wages and working conditions contained in M_1 cost more than M_2 and confer more benefits to employees than M_2, and so on for M_3, etc. Similarly E_1 involves more effort than E_2, etc. Note that each value high up on the south-east north-west diagonal is a Pareto improvement over those lower down. Also, for any horizontal movement westward we have shifts in favor of management, while vertical movements down are moves in favor of the employees. It is quite straightforward that increased adversarial behavior by employees implies less valuable effort. But, it should be equally clear that if managers attempt to minimize cost per effort unit, this increases resentment among employees, so that the effort level is lower than otherwise.

It should appear clear that the relative evaluations in the diagram which imply the nature of the payoff table lead to the prisoner's dilemma solution. For *every* effort option that employees will choose, the management will want to choose motivational system M_n; for every motivational system, the employees will want to choose effort level E_n. The outcome is clearly the prisoner's dilemma outcome since all cooperative outcomes

along the diagonal involve Pareto improvements over the outcome $E_nM'_n$.

We must emphasize that the prisoner's dilemma outcome determined by the latent two-sided adversarial relations between employees and managers is just one of many prisoner's dilemma situations in the firm as a system. At every level in the hierarchy there are other prisoner's dilemmas expressed by the idea of free-rider incentives. It makes sense for every employee to feel that other employees should work relatively effectively so that the firm may prosper and the employee's job and career can be assured. But since each employee is only one of many, there is no necessity for any one employee to feel obliged to put forth a maximal effort, since his contribution is minute compared to the contribution of all others. Thus, each employee may feel that he should follow the free rider incentives and allocate his efforts toward his own rather than the firm's interests. In other words, each employee, if he were a maximizer, would operate on the basis of "the selfish max strategy." Exactly the same sort of thing holds for managers at every level in the managerial hierarchy where the group of managers remains relatively large. It is worthwhile to keep these ideas in mind when we discuss conventions as solutions to the prisoner's dilemma problem, since it will turn out that the conventions that solve the adversarial prisoner's dilemma also solve simultaneously the free-rider incentives type of prisoner's dilemma.

5. CONVENTIONS AS DECISION PROCEDURES

Conventions involve "*transindividual*" choices. In other words, a habit may be a purely individual matter and not involve other people in any way. However, to say that we follow a convention does involve others. Consider the side of the street on which we choose to drive our automobiles. The nature of the situation is reflected in the payoff matrix indicated in Figure 7. If both A and B choose to drive on the right, the reward is fairly high, say 50 utils. Similarly, if both A and B choose to drive on opposite sides, disaster can occur and the penalty is very high, say −500 utils. Similarly if A chooses the right and B chooses the left it is −500 utils. The importance of all this is that it is significant for both A and B to coordinate their behavior with each other. If a conventional forum of driving behavior already exists then it is important for any new individual to choose the same driving convention. It is immaterial whether everyone drives on the right or on the left. In other words

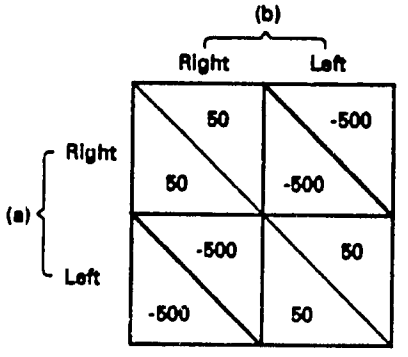


Figure 7. *Payoff matrix.*

we seek conventions *as solutions* to fairly simple coordination problems.

Some coordination problems are of a type for which coordination need not be exact. For example, if two people are to meet each other they may agree on a time but there will usually be a tolerance on either side of the agreed time within which one person would be expected to wait for the other. The same probably holds true with respect to the conventions involved in *pace* of work, or in the *quality* of the work effect. In Figure 8 we illustrate this aspect with respect to *pace*. On the X axis we show the observed average pace of work. On the Y axis we indicate the average reaction pace to the observed pace of work. Thus all possible equilibria will be along a ray drawn at a 45° angle through the origin. The curve R is the reaction curve. Where the observed average pace of work is low, individuals making independent choices will choose, on the average, a pace above the observed rate. On the

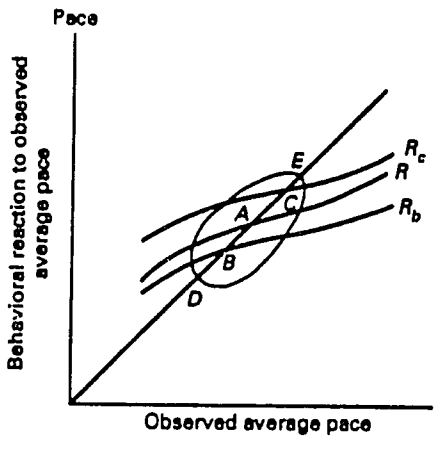


Figure 8. *Behavioral reaction to observed average pace.*

other hand, where the observed pace is high individuals will choose a somewhat lower rate. The point A, the intersection between the two curves, indicates the point at which the aggregate average reaction rate is equal to the average observed rate. However, the curve R does not include the social pressure to induce people to operate closer to the anticipated rate. Hence, we should expect that there will be a curve below the R curve which reflects how people will behave if at every point others apply social pressure to attempt to get individuals to conform to actual behavior. Thus R_b reflects the reaction curve including pressure which is below the point A, while R_c reflects the reaction curve above the point A. The intersections between these two boundary curves are marked by the points B and C in the figure so that the distance BC forms a set of possible equilibrium conventions. Surrounding B and C we can visualize the upper and lower equilibrium positions to the line DE. Of course, on either side of the 45° line we can also visualize equilibrium boundaries reflecting the inert area. The entire equilibrium set is shown by the oblong drawn around the 45° line.

We must keep in mind that not all points of equilibrium are equally good from the point of view of those who choose these equilibrium positions. Some paces of work will be superior to others and the points closest to the point A will involve higher degrees of satisfaction on the average than points further away. Nevertheless, less satisfactory points may be chosen and persist because they are within the inert area bounds.

The convention-choice analysis with respect to pace of effort will also hold for any other aspect of on-the-job activities. Thus, similar considerations hold for *quality* of the effort involved in any activity, for the choice of *activities*, as well as for the time sequence of activities.

6. OTHER ASPECTS OF THE MODEL

For the vertical transmission of pressure and information within the firm, assume there is a clear channel from the top down through the hierarchy. Pressure is received at the top and transmitted down through the hierarchy to the point at which it is supposed to be acted on. However, there may be a loss of pressure at various points in the transmission process. Two general possibilities exist for pressure loss:

(1) pressure received at one level may not equal pressure sent toward the next level; and

(2) pressure sent from one level may not equal pressure received at the next level.

For the system to work on a feedback basis the pressure level must be associated with some activity, and the activity has to be recorded and become part of an observed result. Next, the observed result (OR) has to be sent back through the hierarchy so that pressure is adjusted according to results. Needless to say, the communication system of ORs back up the hierarchy can also be full of obstacles of various kinds so that information is lost or garbled in transmission.

Various ideas we have developed so far can be summed up in Figure 9. We have two basic relations to consider:

$$C = C(M)$$
$$M = M(C) \tag{3}$$

where C stands for cost per unit and M stands for degree of motivation. The curve marked C in the diagram represents cost per capita as a function of the motivating elements in the system. The greater the degree of motivation, the lower the level of cost, up to some point. Beyond some level of motivation cost is a maximum. In the drawing of the curve we assume diminishing returns to increases in motivation. The curve M represents motivation as a function of costs. In part this curve is a reflection of the pressure-observed results communication system within the firm. Thus where costs are high this will increase the motivation toward lower costs, and vice versa. Hence, motivation to reduce costs falls as the cost level declines. The intersection of the curves M and C will determine the equilibrium cost level, and this level can be considerably above the minimum cost level. Note: if the external pressure decreased, then the curve M would shift to M'.

Of course, motivation summarizes a number of elements that contribute to the motivational system. Among these are:

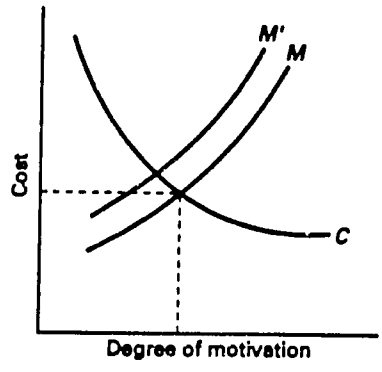


Figure 9. *Relations between cost and motivation.*

(1) the external pressure determined by the environment;
(2) the internal pressure determined by the personalities within the firm and their interaction;
(3) the work satisfaction elements within the firm; and
(4) cross-sectional professional ethics components.

We consider each of these elements in turn.

The environment in which the organization exists creates the pressure. At one extreme we visualize the pressure created by perfect competition and at the other extreme we visualize a completely sheltered situation of some sort. Nevertheless, it is difficult to imagine a complete lack of pressure. To some extent, there are likely to be constraints in every environmental situation. These are limited on the one hand by the maximum budget (or maximum gross revenues) available to the firm, and on the other hand by the concerns of those who use the product or service created by the state enterprise. Even if the budget is completely wasted there is an upper limit in the sense that no organization can have explicitly or implicitly a limitless budget. Nevertheless an organization that can waste completely its gross revenues (including the maximum governmental subsidy) is in a very different situation than firms that face a perfectly competitive environment.

Internal pressure is that pressure for performance that emanates from the conscience or superego of employees of the state enterprise. This notion is related to such ideas as the work ethic, a fair day's work, or other moral notions associated with work responsibility. Such individuals do not necessarily enjoy "carrying out their responsibilities" but it represents something that they feel they have to do.

Work satisfaction is in some sense a different type of motivation than that involved in a work ethic. Those who have a work ethic may or may not enjoy what they are doing. Somebody who responds with satisfaction in carrying out the effort he believes is required for high level performance likes what he is doing, but does not necessarily feel any special obligation to do it. A somewhat special case of this type is the performance of the workaholic who is addicted to work for a variety of reasons, all unrelated to any moral obligation.

Finally, professional standards may generate performance which can appear to be associated with a work ethic but is really quite different. The work ethic does not necessarily involve others. It has to do with an individual sense of obligation to perform under the circumstances. Professional standards involve the approval or disapproval of other members of the profession or craft. Usually this involves considerations which are "cross-sectional" in nature, since it involves concern for the approval or disapproval of others who are frequently outside the firm in question. Of course, craftsmanship may be part of the same phenomenon. None of this is to imply that the various motivating forces operate singly. Any specific individual may be moved at any one time by some complex mixture of a variety of motivating elements.

7. IMPLICATIONS

We argued that there are two sides to external pressure. On the one hand there is pressure from the environment "above" the firm which includes agents of the principals who can impose penalties on the officers of the firm through (1) changing the officers; (2) cutting out functions; (3) cutting the budget; (4) creating partially competing units; and (5) responding in various ways to the observed results. On the other hand, environmental pressure is likely to exist from buyers or users of the firm's services. If there are any alternative sources for these services the buyers or users may shift to other sources for the services and in this way withdraw support from the firm.

In general, we should expect that the greater the environmental pressure, the greater the X-efficiency of the firm. Of course statements like these are made on an other-things-equal basis.

In analyzing the firm, we must keep in mind that the internal pressure coming from the ethical or other cultural values of the individual are substitutes of external pressure in determining performance. This type of pressure will differ from culture to culture.

The reduction in pressure, whether external or internal, is likely to lead to a reduction of cost containment efforts. Activities by members of the firm that can result in the reduction of external pressures are substitutes for cost containment. Since beyond some low level external pressure is viewed as undesirable, an incentive is likely to exist for officers of the enterprise to try to either contain costs or use other means to manipulate the environment so that there is a reduction in external pressure.

It is quite likely that the pressure brought to bear on the firm by users or buyers of the firm's services is likely to be more stable than the pressure coming from above, as it were. The extent to which governmental pressure on the firm is likely to be stable will depend to some degree on

the distance between principals and agents. If this distance is quite remote then we are likely to have a situation in which the agents have a very limited incentive to maintain pressure on the top management of the firm.

Another way of looking at this set of problems is to note that under effort discretion we are likely to have strong free-rider incentives for firm members, and if followed the result will be a prisoner's dilemma solution to the effort problem. The way to overcome the free-rider prisoner's dilemma aspects of the problem is by individuals adopting transindividual choice procedures. These may involve adopting ethical values or social norms or conventions with respect to some of the components of effort.

The effort convention chosen may involve a low effort level in situations where a higher effort level would have been acceptable or even preferred by the members of the state enterprise. Nevertheless it is quite possible for the low effort level to be stable.

The various ideas we have developed suggest some possible policies which may be used in order to increase the X-efficiency of state enterprises. The extent to which any of these policies may be employed will depend on the constraints that exist within the institutional framework under which the state enterprise operates. Thus the possibilities to be mentioned are not necessarily options under all circumstances.

Some of the possibilities for decreasing X-inefficiency are as follows:

(1) We may set up alternatives for buyers or users of the product produced by the enterprise. This may be done by setting up state enterprises to compete with each other, or by setting up portions of such enterprises to compete at some levels, or by reducing or eliminating import restrictions on competing products, or by permitting the private sector to engage in some competing activities.

(2) The previous paragraph dealt with providing greater external pressure in order to stimulate efficiency within the enterprise. But to a considerable degree, internal pressure may be a substitute for external pressure. Thus, we may be able to increase internal pressure if the enterprise is able to choose employees who have internal pressure toward performance from the start. Under such a scheme one of the required traits for employment would be the existence of internal pressure to perform at a high level. The obvious difficulties with such an approach are to be able to clearly identify individuals who possess such internal characteristics, and to induce the bureaucracy to make hiring choices on the basis of such a criterion. The latter is likely to be a more formidable obstacle than the former.

(3) Another approach would be to increase or improve the observed results used as criteria for performance and to improve the relation between the cybernetic system of the observation-pressure relationship.

(4) As an alternative to setting up competing units (in order to create pressure from buyers) we may attempt to put representatives of buyers (consumers) on the board of directors of the state enterprise. A likely difficulty with such a plan is to make sure that such individuals continue to reflect the interests of the buyers rather than take on the coloration and attitudes of other board members.

(5) Another approach would be for the government to sell to components of the firm, say different departments, through an option procedure, the *right* to carry out their activity for a minimum budget. In other words, individuals or producing groups would bid for this right and the ones with the lowest bid would obtain the right. Whether the right would be the right to manage or some other privilege would have to be determined on the basis of the effectiveness of the procedure.

(6) Still another possibility would be for outside agencies to monitor components of the state enterprise by comparing their performance to reasonably similar entities in other enterprises either within or even outside the country.

All of these suggestions do not exhaust the possible ways to decrease X-inefficiency in state enterprises. The main point of all of these suggestions is that it may be possible to find substitutes for the two types of pressure that exist under perfect competition, either by setting up such pressures within the firm, or between components of the firm and somewhat similar components elsewhere.

8. IMPLICATIONS FOR DEVELOPMENT ANALYSIS

The purpose of an organizational model like the foregoing is to help us study the intraorganizational sources of inefficiency. Through this means we may hope to understand why resources allocated to development often yield disappointing results.

Let us turn now to examine in a summary way some of the sources of inefficiency we have considered. Clearly a major source is low effort relative to the optimal effort level. We have seen that a major phenomenon is free riding with respect to effort. However, free riding is limited by effort conventions. The history of the organ-

ization determines the effort level of such conventions. Basically, the way things are done at any specific point in time is a consequence of the way they were done in the past.

Another basic element, closely connected, is the degree of inertia, or what we refer to as the width of the inert areas. Wide inert areas can help us understand a lack of change as being a consequence of insufficient shocks to the system. Inertia describes the general resistance to change that is likely to exist within any system. As a consequence of past experience, people within organizations are quite likely to have built up shelters from pressures for change, as well as shelters from competitive forces. This may result in a lack of introduction of innovations. If shocks are too limited or too few, then either no innovations will occur, or those which do take place are apt to fail to be fully implemented because they are overwhelmed by the inertial forces in the system. Equally importantly, even if innovations take place, other organizational inefficiencies may outweigh any benefits so that the productivity level after the innovation is no greater than it was before. In other words, it is certainly possible for organizational failures to undo the promise inherent in technical innovations.

On a more general level, the implication of using an explicit organizational approach is that it may help to tell us what questions to ask, what to study, and where to focus our analytical attention in order to understand some of the difficulties of fostering development. We can see that a pattern of low-effort production will result from poor organizational performance for any level of investment. In other words, an organizational analysis may help us understand why reasonable strategies and the existence of the requisite resources may fail to get desirable results.

Consider the case of an import-substitution strategy. In principle there may be nothing wrong with attempting to replace imported goods by their production in the home country. There may be some sense in which the cost of the inputs favors such a strategy for some industries. Yet in practice it may not work because the industries are sheltered to an excessive degree, and these shelters result in such inefficient organizational behavior that the inefficiencies overwhelm the advantages of relatively low input costs.

A similar argument can frequently be made for an export-focused strategy. Once again, the input costs may be sufficiently low so that emphasizing the expansion of exports in certain areas (or industries) may in principle represent a proper policy. Nevertheless, the strategy may not work because the country in question may not have the organizational capacities to carry out such a development strategy.

An organizational analysis may help to tell us where to place training resources. Usually the training suggested is of a technical nature. The real deficiencies, however, may lie in managerial, "people-handling" capacities rather than a lack of technical skills. This last is especially important since it is frequently believed that it is a lack of technical skills that is the real deficiency rather than human relations skills. This is part of the general delusion that technical skills involve hard information which is worthwhile acquiring, whereas almost everybody believes they have more than adequate "soft" human relations skills. But human relations skills are required in order to overcome the latent free-riding incentives that exist in organizations.

We have not examined in detail the connection between changes in institutions and their effects on organization behavior. We have, however, alluded to possible institutional changes that increase the degree of competition and hence increase pressure on the organization. Another aspect to keep in mind is that frequently there is an anti-competitive philosophy behind some institutional arrangements. Thus, state ownership or control is frequently connected with a belief in the virtues of centralization and monopoly. To go beyond such broad platitudes would require a consideration of specific institutional arrangements in specific countries. This is clearly beyond the scope of this paper. But the message behind the ideas presented earlier is that we should focus on the incentives inherent in institutional arrangements, and examine to what extent the incentives meet the motivational needs of economic actors.

NOTES

1. Sections 2 and 3 are based on materials published previously in Leibenstein (1981).

2. Section 4 is based on materials published previously in Leibenstein (1982).

42

organizational
overwhelm the
ıut costs.
ıtly be made for
again, the input
ıat emphasizing
rtain areas (or
resent a proper
v may not work
ıay not have the
ry out such a

y help to tell us
es. Usually the
cal nature. The
e in managerial,
her than a lack
specially impor-
d that it is a lack
deficiency rather
is is part of the
ills involve hard
hile acquiring,
ieves they have
ıuman relations
s are required in
ree-riding incen-

connection
and their effects
have, however,
al changes that
ition and hence
ization. Another
equently there is
ıy behind some
us, state owner-
onnected with a
ation and mono-
platitudes would
cific institutional
ıes. This is clearly
But the message
arlier is that we
inherent in insti-
xamine to what
the motivational

nals published pre-

REFERENCES

Hayek, Friedrich, "The use of knowledge in society," *American Economic Review*, Vol. 35, No. 4 (1945), pp. 519–530.

Leibenstein, H., "The prisoner's dilemma in the invisible hand: An analysis of intrafirm productivity," *American Economic Review*, Vol. 72, No. 2 (1982), pp. 92–97.

Leibenstein, H., "X-efficiency theory, productivity and growth," in Herbert Girsch (Ed.), *Towards an Explanation of Economic Growth, Symposium* (Tubingen: J. C. B. Mohr, 1981).

Leibenstein, H., "X-efficiency from concept to theory," *Challenge* (September–October 1979), pp. 13–22.

Shen, T. Y., "The estimation of X-inefficiency in eighteen countries," *Review of Economics and Statistics*, Vol. 66, No. 1 (1984).

World Development, Vol. 17, No. 9, pp. 1375–1387, 1989.
Printed in Great Britain.

0305–750X/89 $3.00 + 0.00
© 1989 Pergamon Press plc

Institutional Innovation and Agricultural Development

VERNON W. RUTTAN
University of Minnesota, St. Paul

Summary. — This paper elaborates a theory of institutional innovation in which shifts in the demand for institutional change are induced by changes in relative resource endowments and by technical change. The supply of institutional innovations responds to advances in social science knowledge and changes in cultural endowments. Case studies drawing on (1) innovations in land tenure and labor relations in the Philippines; (2) export promotion and import substitution of agricultural commodities in East Asia; and (3) farm commodity policy in the United States are presented. Elements of a general institutional innovation model are outlined.

1. INTRODUCTION

Over the last several decades economists have made major contributions to our understanding of the impact of advances in natural science knowledge on technical change and of the impact of technical change on economic growth. We have also significantly advanced our understanding of the sources of demand for and supply of technical change.

In work published in the early 1970s, Yujiro Hayami and I extended the theory of induced technical change and tested it against the history of agricultural development in the United States and Japan (Hayami and Ruttan, 1971 and 1985; also Binswanger and Ruttan, 1978). It is now generally accepted that the theory of induced technical change provides very substantial insight into the process of agricultural development for a wide range of developed and developing countries. Economic historians are increasingly drawing on the theory of induced technical change in attempting to interpret differential patterns of productivity growth among countries and over time (Thirtle and Ruttan, 1986, pp. 60–66).

The demonstration that technical change can be treated as largely endogenous to the development process does not imply that the progress of either agricultural or industrial technology can be left to an "invisible hand" that drives technology along an "efficient" path determined by relative resource endowments. The capacity to advance knowledge in science and technology is itself a product of institutional innovation. Whitehead has insisted that "the great invention of the 19th century was the invention of the method of invention" (Whitehead, 1925, p. 96).

In the case of agriculture, for example, in both Japan and the United States much of the technical change that has led to growth of output per hectare has been produced by public sector institutions. These institutions — state (or prefectoral) and federal (or national) agricultural experiment stations — obtained their resources in the political marketplace and allocated their resources through bureaucratic mechanisms. The success of the theory of induced technical change gives rise, therefore, to the need for a more careful consideration of the sources of institutional innovation and design.

In this paper I elaborate a theory of institutional innovation in which shifts in the demand for institutional change are induced by changes in relative resource endowments and by technical change. I also consider the impact of advances in social science knowledge and of cultural endowments on the supply of institutional change. I then present three case studies of institutional innovation in an attempt to illustrate the plausibility of the induced institutional innovation perspective. I then present the elements of a more general model of institutional change. The perspective on the role of institutional change in the process of economic development presented in this paper is much more positive than the views that were held by the American institutional school or in the recent literature on social choice and collective action.

2. SOURCES OF DEMAND AND SUPPLY OF INSTITUTIONAL INNOVATION[1]

Institutions are the rules of a society or of organizations that facilitate coordination among people by helping them form expectations which each person can reasonably hold in dealing with others. They reflect the conventions that have evolved in different societies regarding the behavior of individuals and groups relative to their own behavior and the behavior of others. In the area of economic relations, institutions have a crucial role in establishing expectations about the rights to use resources in economic activities and about the partitioning of the income streams resulting from economic activity — "institutions provide *assurance* respecting the actions of others, and give order and stability to expectations in the complex and uncertain world of economic relations" (Runge, 1981a, p. xii. Also Commons, 1950, p. 24; Knight, 1952, p. 51; Runge, 1981b). In order to perform the essential role of forming reasonable expectations in dealings among people, institutions must be stable for an extended time period. But institutions, like technology, must also change if development is to occur.

Shifts in the demand for institutional innovation or improvements in institutional performance may arise from a wide variety of sources. Douglass North and Robert Thomas (1970; 1973) attempted to explain the economic growth of Western Europe between 900 and 1700 primarily in terms of innovation in the institutional rules that governed property rights. A major source of institutional innovation was, in their view, the rising pressure of population against increasingly scarce resource endowments. Theodore W. Schultz (1968), focusing on more recent economic history, identified the rising economic value of labor during the process of economic development as a primary source of institutional innovation. North and Thomas would apparently have agreed with Schultz that "it is hard to imagine any secular economic movement that would have more profound influence in altering institutions than would the movement of wages relative to that of rents" (Schultz, 1968, p. 1120). Both North and Thomas and Schultz would today probably give greater attention to the role of expected payoffs as a source of demand for institutional change. It also seems more apparent today than a decade ago that in nonmarket environments, or in environments where prices are severely distorted, the shadow prices that reflect the real terms of trade among factors and products (or the gap between shadow and market prices) convey information to economic and political entrepreneurs that leads to shifts in the demand for institutional innovation and performance.

The Marxian tradition has emphasized the importance of technical change as a source of demand for institutional change. Marx insisted that: "At a certain stage of their development, the material forces of production in society come in conflict with the existing relations of production, or — what is but a legal expression for the same thing — with the property relations within which they had been at work before. From forms of development of the forces of production these relations turn into their fetters. Then comes the period of social revolution. With the change of the economic foundation the entire immense superstructure is more or less rapidly transformed" (Marx, 1913, pp. 11–12).

There is a supply as well as a demand dimension in institutional change. Collective action leading to changes in the supply of institutional innovations may be generated by tension among interest groups. The supply of institutional innovations is strongly influenced by the distribution of political resources and by the cost of achieving social consensus (or of suppressing opposition). It also depends critically on cultural endowments, including ideology and religion. Advances in knowledge in the social sciences (and in related professions such as law, administration, planning, and social service) can reduce the cost of institutional change in a somewhat similar manner as advances in the natural sciences reduce the cost of technical change.

The induced innovation perspective suggests that technical and institutional change are highly interdependent and must be analyzed within a context of dialectal interaction.

The sources of demand for technical and institutional change are similar. A rise in the price of land (or natural resources) in relation to the price of labor induces technical change designed to release the constraints on production that result from an inelastic supply of land and, at the same time, induces institutional changes that lead to greater precision in the definition and allocation of property rights in land. A rise in the price of labor in relation to the price of land (or natural resources) induces technical changes designed to permit the substitution of capital for labor and, at the same time, induces institutional changes designed to enhance the productive capacity of the human agent and to increase the workers' control over the conditions of employment. The new income streams generated by technical change and by gains in institutional efficiency induce change in the relative demand for commodities and services, and open up new and

more profitable opportunities for product innovations. The new income streams generated by either technical or institutional change induce further institutional changes designed to modify the way new income streams are partitioned among factor owners and to alter the distribution of income among individuals and classes.

Shifts in the supply of technical and institutional change are also generated by similar forces. Advances in knowledge in science and technology reduce the cost of the new income streams that are generated by technical change. Advances in knowledge in the social sciences and related professions reduce the cost of the new income streams that are generated by institutional change — by improved institutional performance, by new institutions, and by conflict resolutions.

There are, of course, multiple sources of both technical and institutional change. And there are autonomous as well as induced sources of both technical and institutional change. But there have been two very pervasive sources of institutional change during the last century that are particularly relevant to the cases discussed in this paper.

One has been the closing of the land frontier. Prior to the beginning of this century almost all increases in agricultural production came from expansion in land area. By the first decade of the next century, almost all increases in agricultural production will have to come from more intensive land use — from higher yields per unit of land area. This is the most dramatic change in agriculture since neolithic women invented it. And it is occurring in the remarkably short period of a single century.

The second major source of institutional innovation is the rising economic value of the human agent. Within a single century, the value of the human agent per unit of time has, in western societies, risen by a multiple of four or five. This change occurred first in the countries of new settlement and Western Europe. Since mid-century it has occurred in Japan and in several small countries in East Asia. It is well underway in Latin America. The sources of these changes are still not well understood, but the implications for institutional change can hardly be underestimated.

3. INSTITUTIONAL INNOVATION IN LAND TENURE AND LABOR RELATIONS: A PHILIPPINE CASE[2]

In some cases the demand for institutional innovation can be satisfied by the development of new forms of property rights, more efficient market institutions, or even by evolutionary changes arising out of direct contracting by individuals at the level of the community or the firm. In other cases, where externalities are involved, substantial political resources may have to be brought to bear to organize nonmarket institutions in order to provide for the supply of public goods.

Economic historians have provided us with a number of cases where changes in factor endowments, technical change, and growth in product demand have induced changes in property rights and contractual arrangements. In the 1985 edition of *Agricultural Development*, Yujiro Hayami and I discuss historical examples from the United Kingdom, Thailand and Japan. Although exceedingly useful, I always feel somewhat insecure about the inferences that can be drawn from the historical cases. Research conducted by Yujiro Hayami and Masao Kikuchi in the Philippines during the late 1970s has enabled us to examine a more contemporary example of the interrelated effects of changes in resource endowments and technical change on the demand for institutional change in land tenure and labor relations. The case is particularly interesting because the institutional innovations occurred as a result of private contracting among individuals. The study is unique in that it is based on a rigorous analysis of microeconomic data in a village over about a 20 year period.

(a) *Changes in technology and resource endowments*

Between 1956 and 1976, rice production per hectare in the study village rose dramatically, from 2.5 to 6.7 metric tons per hectare per year. This was due to two technical innovations. In 1958, the national irrigation system was extended to the village. This permitted double-cropping to replace single-cropping, thereby substantially increasing the annual production per hectare of rice land. The second major technical change was the introduction in the late 1960s of the modern high-yielding rice varieties. The diffusion of modern varieties was accompanied by increased use of fertilizer and pesticides and by the adoption of improved cultural practices such as straight-row planting and intensive weeding.

Population growth in the village was rapid. Between 1966 and 1976 the number of households rose from 66 to 109 and the population rose from 383 to 464, while cultivated area remained virtually constant. The number of landless laborer households increased from 20 to 54. In

1976, half of the households in the village had no land to cultivate, not even land for rent. The average farm size declined from 2.3 to 2.0 hectares.

The land is farmed primarily by tenants. In 1976, only 1.7 hectares of the 108 hectares of cropland in the village were owned by village residents. In both 1956 and 1966, 70% of the land was farmed under share tenure arrangements. In 1963, a new agricultural land reform code was passed which was designed to break the political power of the traditional landed elite and to provide greater incentives to peasant producers of basic food crops. A major feature of the new legislation was an arrangement that permitted tenants to initiate a shift from share tenure to leasehold, with rent under the leasehold set at 25% of the average yield for the previous three years. Implementation of the code between the mid-1960s and the mid-1970s resulted in a decline in the percentage of land farmed under share tenure to 30%.

(b) *Institutional innovation*

The shift from share tenure to lease tenure was not, however, the only change in tenure relationships that occurred between 1966 and 1976. There was a sharp increase in the number of plots farmed under subtenancy arrangements. The number increased from one in 1956, to 16 in 1976. Subtenancy is illegal under the land reform code. The subtenancy arrangements are usually made without the formal consent of the landowner. All cases of subtenancy were on land farmed under a leasehold arrangement. The most common subtenancy arrangement was 50–50 sharing of costs and output.

The incentive for the emergence of the subtenancy institution was that the rent paid to landlords under the leasehold arrangement was below the equilibrium rent — the level which would reflect both the higher yields of rice obtained with the new technology and the lower wage rates implied by the increase in population pressure against the land.

To test this hypothesis, market prices were used to compute the value of the unpaid factor inputs (family labor and capital) for different tenure arrangements during the 1976 wet season. The results indicate that the share-to-land was lowest and the operators' surplus was the highest for the land under leasehold tenancy. In contrast, the share-to-land was the highest and no surplus was left for the operator who cultivated the land under the subtenancy arrangement (Table 1). Indeed, the share-to-land when the land was farmed under subtenancy was very close to the sum of the share-to-land plus the operators' surplus under the other tenure arrangement. A substantial portion of the economic rent was captured by the leasehold tenants in the form of operators' surplus. On the land farmed under a subtenancy arrangement, the rent was shared between the leaseholder and the landlord.

A second institutional change, induced by higher yields and the increase in population pressure, has been the emergence of a new pattern of employer-labor relationship between farm operators and landless workers. According to the traditional system called *hunusan*, laborers who participated in the harvesting and threshing received a one-sixth share of the harvest. By 1976, most of the farmers (83%) adopted a system called *gamma*, in which participation in the harvesting operation was limited to workers who had performed the weeding operation without receiving wages.

The emergence of the *gamma* system can be interpreted as an institutional innovation designed to reduce the wage rate for harvesting to a level equal to the marginal productivity of labor. In the 1950s, when the rice yield per hectare was low and labor was less abundant, the one-sixth share may have approximated an equilibrium wage level. With the higher yields and the more abundant supply of labor, the one-sixth share became larger than the marginal product of labor in the harvesting operation.

To test the hypothesis that the *gamma* system was adopted rapidly primarily because it represented an institutional innovation that permitted farm operators to equate the harvesters' shares of output to the marginal productivity of labor, imputed wage costs were compared with the actual harvesters' share (Table 2). The results indicate that a substantial gap existed between the imputed wage for the harvesters' labor alone and the actual harvesters' shares. This gap was eliminated if the imputed wages for harvesting and weeding labor were added.

Those results are consistent with the hypothesis that the changes in institutional arrangements governing the use of production factors were induced when disequilibria between the marginal returns and the marginal costs of factor inputs occurred as a result of changes in factor endowments and technical change. Institutional change, therefore, was directed toward the establishment of a new equilibrium in factor markets.

(c) *Efficiency and equity*

It is important to recognize that subtenancy and *gamma* contracts were the institutional

Table 1. *Factor shares of rice output per hectare, 1976 wet season*

	Number of plots	Area (ha)	Rice output	Factor shares*						
				Current inputs	Landowner	Subtenancy	Total	Labor	Capital†	Operators' surplus
			kg/ha							
Leasehold land	44	67.7	2,889 (100.0)	657 (22.7)	567 (19.6)	0 (0)	567 (19.6)	918 (31.8)	337 (11.7)	410 (14.2)
Share tenancy land	30	29.7	2,749 (100.0)	697 (25.3)	698 (25.4)	0 (0)	698 (25.4)	850 (30.9)	288 (10.5)	216 (7.9)
Subtenancy land	16	9.1	3,447 (100.0)	801 (23.2)	504 (14.6)	801‡ (23.2)	1,305 (37.8)	1,008 (29.3)	346 (10.1)	−13 (−0.4)

Source: Hayami and Kikuchi (1981), pp. 111–113.
*Percentage shares are shown in parentheses.
†Sum of irrigation fee and paid and/or imputed rentals of carabao, tractor and other machines.
‡Rents to subleasors in the case of pledged plots are imputed by applying the interest rate of 40% crop season (a mode in the interest rate distribution in the village).

Table 2. *Comparison between the imputed value of harvesters' share and the imputed cost of* gamma *labor*

	Based on employers' data	Based on employees' data
Number of working days of *gamma* labor (days/ha)*		
Weeding	20.9	18.3
Harvesting/threshing	33.6	33.6
Imputed cost of *gamma* labor (P/ha)†		
Weeding	167.2	146.4
Harvesting/threshing	369.6	369.6
(1) Total	536.8	516.0
Actual share of harvesters:		
In kind (kg/ha)‡	504.0	549.0
(2) Imputed value (P/ha)§	504.0	549.0
(2) − (1)	−32.8	33.0

Source: Hayami and Kikuchi (1981), p. 121.
*Includes labor of family members who worked as *gamma* laborers.
†Imputation using market wage rates (daily wage = P8.0 for weeding, P11.0 for harvesting).
‡One-sixth of output per hectare.
§Imputation using market prices (1 kg = P1).

innovations to facilitate more efficient resource allocations through voluntary agreements by assigning more complete private property rights. The land reform laws gave tenants strong protection of their tenancy rights with the result that a part of land property rights, which is the right to continue tilling the soil at a rent lower than the marginal product of land, was assigned to tenant operators. But the laws prohibited tenants from renting their land to someone else who might utilize it more efficiently, when they became elderly or found more profitable off-farm employment, for example. Subtenancy was developed to reduce such inefficiency due to the institutional rigidity in the land rental market based on the land reform programs. Likewise, the *gamma* system was developed to counteract the institutional rigidity in the labor market based on the traditional custom in the rural community in the form of a fixed harvester's share.

It might appear that these institutional innovations increased efficiency at the expense of equity. But, if the subtenancy system had not been developed, the route would have been closed for some of the landless laborers to become farm operators. If the implicit wage rate for harvesting work had been raised in the absence of the *gamma* contract, it might have encouraged mechanization in threshing and thereby reduced employment and labor earnings. It must be recognized that the institutional innovations that resulted in more efficient markets as a result of the assignment of more complete private property rights do not necessarily impair equity, as is often argued by Marxist and populist critiques of private market institutions.

In the case reviewed here the induced innovation process leading toward the establishment of equilibrium in land and labor markets occurred very rapidly in spite of the fact that many of the transactions — between landlords, tenants, and laborers — were less than fully monetized. Informal contractual arrangements or agreements were utilized. The subleasing and the *gamma* labor contract evolved without the mobilization of substantial political activity or bureaucratic effort. Indeed, the subleasing arrangement evolved in spite of legal prohibition! Where substantial political and bureaucratic resources must be mobilized to bring about technical or institutional change, the changes can be expected to occur more slowly. In the cases discussed in the next two sections, the mobilization of political resources plays a much more important role.

A continuing puzzle in the agricultural development literature is an understanding of the conditions under which spatial and intertemporal markets for commodities and services emerge. Binswanger and Rosenzweig (1986) have recently laid out a very useful framework for interpreting the implications of risk and information costs for the absence of markets and for analyzing the implication of lack of markets for production behavior. A series of case studies of the emergence of factor, product, and service markets could be extremely useful in advancing our understanding of institutional change.

4. EXPORT PROMOTION AND IMPORT SUBSTITUTION: EXAMPLES FROM EAST ASIA[3]

The second case of institutional innovation is the rather dramatic change that has taken place in sectoral patterns of import substitution and export promotion in East Asia since the beginning of industrial development. Many observers have credited the export-oriented industrial policies pursued first by Japan, and later by Taiwan and South Korea, with creating an economic

environment that has been exceptionally favorable to economic growth. It has also been noted, with a good deal of puzzlement, that these same countries are pursuing import substitution agricultural policies. It is clear that these policies have imposed rather large welfare losses on all three economies. Does economic rationality vanish at the edge of the rice fields?

A series of studies by Kym Anderson, Yujiro Hayami and several colleagues has helped to clarify the economic and political forces that have given rise to the transition from earlier agricultural export and industrial import-substitution oriented regimes to the present industrial export promotion and agricultural import-substitution regimes.

The transition from an export-oriented agricultural policy in Japan began shortly after the turn of the century. In the 1890s, Japan shifted from being a small net exporter of rice to becoming a net importer of rice. A tariff was first imposed on rice imports in 1904. After World War I, the protection afforded to Japanese rice producers was reduced by allowing duty-free imports from Korea and Taiwan under a policy of imperial self-sufficiency. During this period, land taxation was reduced and expenditures on agricultural research and rural infrastructure were expanded. During the first decade after World War II, Japanese farmers received prices that were slightly above world market prices. Since the mid-1950s, however, nominal rates of agricultural protection (producers price/border price) have escalated rapidly.

The transition to agricultural import substitution in Korea and Taiwan came much later. In the 1950s, both countries were pursuing industrial import-substitution policies. Nominal rates of protection for most agricultural commodities were negative. During the early 1960s, both South Korea and Taiwan shifted from industrial import-substitution to export-oriented policies. Nominal rates of protection for agriculture turned slightly positive in the 1960s and escalated rapidly in the 1970s in both South Korea and Taiwan. This transition from taxing to protecting agriculture is not unlike the changes that occurred in Western Europe during the process of industrialization. What is remarkable about the East Asian experience, particularly that of South Korea and Taiwan, is the extraordinary speed of the transition.

Anderson, Hayami and their colleagues have attempted to explore the sources of both demand and supply for the rapid emergence of protectionist agricultural policies. In the case of Japan, the demand for protection was based on the economic cost to rural families and communities and resulting political stress that would have accompanied rapid structural adjustment. Japanese agriculture lost comparative advantage — measured in terms of labor productivity, relative to both Japanese industry and United States agriculture — very rapidly after the early 1950s. The loss of comparative advantages in Korea and Taiwan in the late 1960s and 1970s was even more rapid (Anderson and Hayami, 1986, p. 40). The impact of structural adjustment costs would have been borne largely by a single generation of rural people.

There were also a number of factors that shifted the supply curve for protectionism to the right. Economic growth rapidly reduced both the share of the consumer budget accounted for by food purchased in the market and the tax burden of producer subsidies. It was advantageous to Japanese commercial and industrial interests to accede to policies that would maintain farmers' commitment to the conservative Liberal Democratic Party (LDP). Large numbers of Japanese industrial workers and part-time farmers have strong emotional links to rural households and to the political imagery of food self-sufficiency.

The situation in Taiwan and South Korea was not unlike that in Japan. The potential political threat from North Korea has provided additional impetus for the government, the industrial and the commercial interests to assure rural commitment to political stability in South Korea.

The conclusions that Anderson and Hayami draw from their East Asian analysis have been tested using cross-section data from a large number of developed and developing countries. The cross-sectional evidence suggests that as economies grow they tend to change from taxing to assisting or protecting agriculture. Anderson and Hayami conclude that this change occurs at an earlier stage of economic growth, the weaker the countries' comparative advantage in agriculture. Their analysis also suggests that these changes occur more rapidly the faster the rate of economic growth and the faster the decline in agricultural comparative advantage (Anderson and Hayami, 1986, p. 1).

This conclusion is reinforced by the results of the analysis by Robert H. Bates and William P. Rogerson (1980) that as the share of agricultural population declines, its desirability as a coalition partner rises. Furthermore, the policies pursued by South Korea and Taiwan are not inconsistent with the model suggested by Irma Adelman, which implies the desirability of shifting to an agricultural demand-led industrialization policy once the process of development is well underway (Adelman, 1984).

The implications for other developing coun-

tries seem quite clear. As other developing countries enter into a period of rapid industrial growth, they are also likely to adopt increasingly protectionist policies. This switch is likely to occur at relatively low levels of per capita income, as in South Korea and Taiwan, in situations where comparative advantage in agriculture is weak or rapidly eroding. It is difficult to believe that the growth of agricultural protectionism in the world economy will be significantly reversed in the next several decades.

The question remains, why, in view of the very large deadweight losses associated with the protectionist policies pursued in both East Asia and Western Europe, alternative policies that would delink income support from commodity prices have not been developed? This is a particularly difficult challenge to economics and other social science research. In the United States, the efforts to bring about a delinkage between commodity price supports and income support for farm families began in the mid-1940s. In the next section, I review the history of this effort. Particular attention will be given to the role of social science knowledge in shifting the supply curve for institutional innovation to the right.

5. FARM COMMODITY POLICY IN THE UNITED STATES[4]

The late 1950s and early 1960s were a period of remarkable vigor in agricultural policy research and in institutional innovation in the design of agricultural commodity policy. Much of the professional discussion during this period was dominated by the "supply management" proposals developed and championed by Willard Cochrane. Cochrane served as an advisor to Kennedy during the 1960 campaign, assisted in the drafting of a campaign "white paper" on agricultural policy, and was brought into the Kennedy administration as director of agricultural economics. The design of the commodity program provisions of the proposed Food and Agriculture Act of 1962 was based on the supply management ideas that Cochrane had worked out over the previous decade and a half. But the most significant policy innovations in the new legislation that finally emerged out of this period drew more heavily on the compensatory or direct payment ideas that were first formally proposed to the Congress in 1949 by Secretary of Agriculture Charles F. Brannan than on the supply management proposals developed by Cochrane (Ruttan, 1984).

In putting the emergence of proposals for direct or compensatory income payments into perspective, it is useful to recall the environment in which the earlier agricultural programs of the 1930s were initiated. The designers of commodity price programs during the first Roosevelt administration were not able to draw on an extensive body of either program experience or professional analysis. Their arguments drew on limited data sources and weak understanding of the agricultural sector implications of macroeconomic policy. The extent to which the behavior of agricultural commodity and financial markets reflected the dramatic increase in unemployment and the decline in national income was not clearly understood. It was not until the 1940s that the dialogue between theory, method, and data had advanced to the point at which the agricultural economics literature began to reflect adequately an understanding of what today can be recognized as the Schultz-Cochrane paradigm regarding the macroeconomic basis for the farm crisis of the 1930s, or the implications of macroeconomic policy for the design of agricultural programs (Brandow, 1977).

What has the evolution of United States agricultural commodity policy since the 1920s revealed about the demand for and supply of social science knowledge? What has it shown about how such knowledge contributes to institutional design and innovation? A first lesson is that deficiencies in social science knowledge have at times imposed a substantial burden on the design of economic policy.

The depression of the early 1930s resulted in a dramatic increase in demand for social science knowledge in the design of policies and programs. But the capacity of social scientists to respond to such opportunities with effective program design was itself dependent on the state of social science knowledge. Roosevelt's election resulted in a discrete shift to the right in the supply function for institutional innovation in agricultural policy. The economists who contributed to the design of the commodity and price policies of the 1930s were clearly among the most brilliant members of the profession. But the economic theory and economic research on which they were forced to draw for policy design was clearly underdeveloped. And the policies they designed have imposed a continuing burden on professional dialogue in the field of agricultural policy and heavy social costs on both farmers and consumers.

In spite of advances in the understanding of macroeconomic relationships during the 1940s, it seems apparent that the limited ability to translate that understanding into a system of demand and supply relationships and to estimate empirically the parameters of commodity and sector

models imposed a severe burden on both in the design and the acceptance of the Brannan Plan. Except for a few illustrative estimates for individual perishable commodity programs (for hogs, eggs, potatoes, and milk and milk products), Secretary Brannan was not able to present to the Congress overall cost estimates for implementing his proposals.

A second lesson is that the innovations in agricultural commodity programs were induced by fundamental economic forces associated with the development of the American economy and the agricultural economy in particular. The timing of the institutional innovations of the 1920s and 1930s was clearly influenced by the political response to the collapse of land prices in the early 1920s and the Great Depression of the 1930s.

Yet, in retrospect it appears that there were even more fundamental forces operating in the agricultural economy to induce institutional innovation. The share of farm assets accounted for by capital inputs rose relative to the share accounted for by land from the 1820s. The value added at the farm level had declined as a share of the value of farm sales from the end of the Civil War. New technology embodied in inputs purchased from the nonagricultural sector had become a major source of productivity growth.

Before the beginning of this century, the gains in productivity in American agriculture were almost entirely a consequence of increased mechanization. The technological revolution of the 19th century contributed to increasing output per worker but contributed very little to growth in aggregate output (Hayami and Ruttan, 1971, pp. 138–152). The period immediately after the turn of the century was a period of technological stagnation. But by the mid-1920s a new biological technology capable of enhancing output per acre and output per unit of breeding stock was beginning to come on stream. It was becoming possible to increase aggregate output more rapidly than aggregate demand.

In the absence of public intervention in agricultural commodity markets, the gains from the new technology would have been transferred almost immediately from agricultural producers to consumers. In this environment, it should not have been surprising that farmers would be unsatisfied with policies that protected them only from the effects of cyclical fluctuations in economic activity. Although farmers and farm leaders articulated these demands in different terms, it seems clear in retrospect that they were demanding economic policies that would dampen the transfer of productivity gains from farm producers to consumers.

6. TOWARD A MORE COMPLETE MODEL OF INSTITUTIONAL CHANGE

In closing, I would like to reflect on the directions that future work might take in efforts to develop a more analytical approach to understanding the process of institutional change. The elements of a more complete model that maps the general equilibrium relationships among resource endowments, cultural endowments, technology and institutions are illustrated in Figure 1. The model suggests the importance of going beyond the conventional general equilibrium model in which resource endowments, technologies, institutions and culture are treated as given. In the study of long-term social and economic change, the relationships among the several variables must be treated as recursive. The formal microeconomic models used in the Hayami-Ruttan work and in the work of others to analyze the supply and demand for technical and institutional change can be thought of as "nested" within the general equilibrium framework of Figure 1.

One advantage of the "pattern model" outlined in Figure 1 is that it helps to identify areas of ignorance. Our capacity to model and test the relationships between resource endowments and technical change is relatively strong. Our capacity to model and test the relationships between cultural endowments and either technical or institutional change is relatively weak. A second advantage of the model is that it is useful in identifying the components that enter into other attempts to account for secular economic and social change. Failure to analyze historical change in a general equilibrium context tends to result in an unidimensional perspective on the relationships bearing on technical and institutional change.

For example, historians working within the Marxist tradition often tend to view technical change as dominating both institutional and cultural change. In his book *Oriental Despotism*, Karl Wittfogel views the irrigation technology used in wet rice cultivation in East Asia as determining political organization (Wittfogel, 1957). As it applies to Figure 1, his primary emphasis was on the impact of resources and technology on institutions (B) and (C).

A serious misunderstanding can be observed in contemporary neo-Marxian critiques of the green revolution. These criticisms have focused attention almost entirely on the impact of technical change on labor and land tenure relations. Both the radical and populist critics have emphasized relation (B). But they have tended to ignore relationships (A) and (C). This bias has led to

460

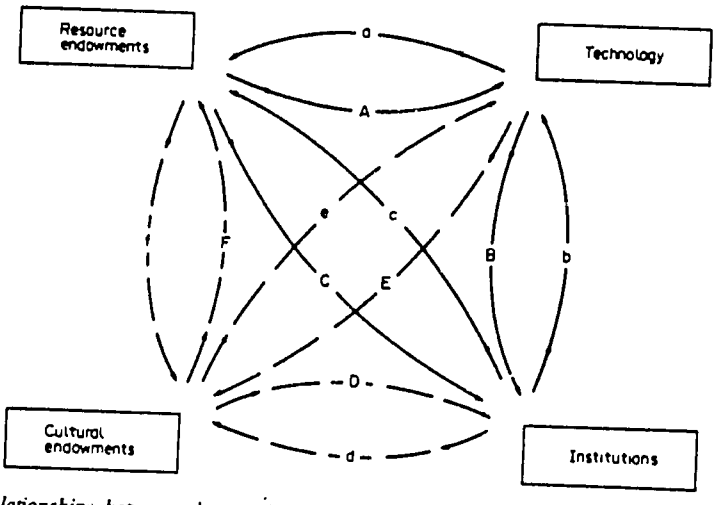


Figure 1. *Interrelationships between changes in resource endowments, cultural endowments, technology, and institutions.*

repeated failure to identify effectively the separate effects of population growth and technical change on the growth and distribution of income.

The analytical power of the more complete induced innovation model has been illustrated in the Laguna Village study by Hayami and Kikuchi (1981). In the Laguna (Philippines) they studied increases in population pressure (C) and the higher incomes generated by technical change in rice production (B) that resulted in substantial change in both land tenure and labor market relationships between the mid 1950s and the mid 1970s.

Armen Alchian and Harold Demsetz identify a primary function of property rights as guiding incentives to achieve greater internationalization of externalities (Alchian and Demsetz, 1973). They consider that the clear specification of property rights reduces transaction costs in the face of growing competition for the use of scarce resources as a result of population growth and/or growth in product demand. Douglass North and Robert P. Thomas, building on the Alchian-Demsetz paradigm, attempted to explain the economic growth of Western Europe between 900 and 1700 primarily in terms of changes in property institutions (North and Thomas, 1970; 1973; Field, 1981). During the 11th and 13th centuries the pressure of population against increasingly scarce land resources induced innovations in property rights that in turn created profitable opportunities for the generation and adoption of labor-intensive technical changes in agriculture. The population decline in the 14th and 15th centuries was viewed as a primary factor leading to the demise of feudalism and the rise of the national state (Figure 1, line C). These institutional changes in turn opened up new possibilities for economies of scale in non-agricultural production and in trade (Figure 1, line b).

In a more recent work, Mancur Olson has emphasized the proliferation of institutions as a source of economic decline (Olson, 1982; North, 1983). He also regards broad-based, encompassing organizations as having incentives to generate growth and redistribute incomes to their members with little excess burden. For example, a broadly based coalition that encompasses the majority of agricultural producers is more likely to exert political pressure for growth-oriented policies that will enable its members to obtain a larger share of a larger national product than a smaller organization that represents the interests of the producers of a single commodity. Small organizations representing narrow interest groups are more likely to pursue the interests of their members at the expense of the welfare of other producers and the general public. In contrast, an even more broadly based farmer-labor coalition would be more concerned with promoting economic growth than would an organization representing a single sector. But large groups, in Olson's view, are inherently unstable because rational individuals will not incur the costs of contributing to the realization of the large group program — they have strong incentives to act as free riders. As a result, organizational "space" in a stable society will be increasingly occupied by special interest "distri-

butional coalitions." These distributional coalitions make political life divisive. They slow down the adoption of new technologies (Figure 1, line b) and limit the capacity to reallocate resources (Figure 1, line c). The effect is to slow down economic growth, or in some cases initiate a period of economic decline.

While substantial progress has been made in economics, at least within a partial equilibrium framework, toward analyzing the sources and impact of technical and institutional change, almost no attention has been devoted by economists to the role of cultural endowments. To the extent that cultural endowments are considered at all by economists, they tend to be subsumed under the concept of tastes. And tastes, even more so than technology and institutions, are regarded as not subject to economic analysis.[5]

At an intuitive level we have little difficulty in accepting the view that cultural endowments, including religion and ideology, exert at least some influence on the supply of institutional innovation. Cultural endowments make some forms of institutional change less costly to establish and impose severe costs on others.

It has been argued, for example, the traditional moral obligation in the Japanese village community to cooperate in communal infrastructure maintenance has made it less costly to implement rural development programs than in societies lacking such traditions (Ishikawa, 1981, pp. 325–347). The traditional patterns of cooperation have represented an important cultural resource on which to erect modern forms of cooperative marketing and joint farming activities. In China, communist ideology, reinforced by the lessons learned during the guerrilla period in Yenan, inspired the mobilization of communal resources to build irrigation systems and other forms of overhead capital (Schran, 1975). Similar cultural endowments are not available in South Asian villages where, for example, the caste structure inhibits cooperation and encourages specialization.

In the cases cited above, cultural endowments acted to shift the supply of institutional innovation to the right — to reduce the cost of institutional change. In the development literature, cultural endowments are more frequently viewed as obstacles to technical or institutional change. Kusum Nair insists that the differential response to the green revolution seed-fertilizer technology among regions in India can be explained, at least in part, on cultural grounds (Nair, 1979). It has been argued that a primary explanation for British economic decline over the last century has been a set of cultural changes associated with the "gentrification" of bourgeois culture — "the rooting of pseudoaristocratic attitudes and values on upper-middle-class educated opinion, shaped an unfavorable context for economic endeavor" (Wiener, 1981).

The first postwar generation of development economists gave prominence, at least at the rhetorical level, to the role of cultural endowments in constraining or facilitating economic growth (Ruttan, 1988). They accepted the body of scholarship in history, philosophy, anthropology, sociology and political science that insisted that cultural endowments exerted major impact on behavior and hence on the response in traditional societies to the opportunities associated with the modernization of community life and the possibilities of national economic development (Hagen, 1962). Professional opinion has, however, not dealt kindly with the reputations of those development economists who have made serious attempts to incorporate cultural variables into development theory or into the analysis of the development process. But in spite of the failure of research on the economic implications of cultural endowments to find a secure place in economic development literature or thought, the conviction that "culture matters" remains pervasive in the underworld of development thought and practice. The fact that the scholars and practitioners of development are forced to deal with cultural endowments at an intuitive level rather than in analytical terms should be regarded as a deficiency in professional capacity rather than as evidence that culture doesn't matter. In my judgment, it is time for a new generation of development economists to again take stock of the advances in the related social sciences and attempt to assess what they can contribute to our understanding of the development process and to institutional design.

NOTES

1. This section draws on material that is discussed in considerably more detail in Ruttan and Hayami (1984); Hayami and Ruttan (1985, pp. 94–114); Binswanger and Ruttan (1978, pp. 327–357).

2. The material summarized in this section is discussed most fully in Hayami and Kikuchi (1981, pp. 67–123). See also Ruttan and Hayami (1984) and Hayami and Ruttan (1985, pp. 98–103).

3. This section draws very heavily on a series of studies of the political economy of agricultural protectionism in East Asia by Kym Anderson, Yujiro Hayami and several other colleagues (Anderson and Hayami, 1986). For a very useful analysis of the sources of industrial import substitution policies in the initial stages of industrial development in the United States, see Pincus (1975, 1977).

4. The material presented in this section is presented in greater detail in Ruttan (1984).

5. See Stigler and Becker (1977). For an alternative view see von Weisäcker (1971).

REFERENCES

Adelman, Irma, "Beyond export-led growth," *World Development*, Vol. 12, No. 9 (1984), pp. 937–949.

Alchian, Armen, and Harold Demsetz, "The property right paradigm," *The Journal of Economic History*, Vol. 33 (1973), pp. 16–27.

Anderson, Kym, and Yujiro Hayami, *The Political Economy of Agricultural Protection: East Asia in International Perspective* (Sydney: Allen and Unwin, 1986).

Bates, Robert H., and W. P. Rogerson, "Agriculture in development: A coalition analysis," *Public Choice*, Vol. 32, No. 5 (1980), pp. 513–527.

Binswanger, Hans P., and Mark R. Rosenzweig, "Behavioral and material determinants of production relations in agriculture," *Journal of Development Studies*, Vol. 22 (April 1986), pp. 503–539.

Binswanger, Hans P., and Vernon W. Ruttan, *Induced Innovation: Technology, Institutions and Development* (Baltimore, MD: Johns Hopkins University Press, 1978).

Brandow, G. E., "Policy for commercial agriculture, 1945–71," in Lee R. Martin (Ed.), *A Survey of Agricultural Economics Literature*, Vol. I (Minneapolis: University of Minnesota Press, 1977).

Commons, John R., *The Economics of Collective Action* (New York: Macmillan Co., 1950).

Field, Alexander J., "The problem with neoclassical institutional economics: A critique with special reference to the North/Thomas model of pre-1500 Europe," *Explorations in Economic History*, Vol. 18 (1981), pp. 174–198.

Fusfeld, Daniel R., "The conceptual framework of modern economics," *Journal of Economic Issues*, Vol. 14 (March 1980), pp. 1–52.

Hagen, Everett E., *On the Theory of Social Change: How Economic Growth Begins* (Homewood, IL: The Dorsey Press, 1962).

Hayami, Yujiro, and Masao Kikuchi, *Asian Village Economy at the Crossroads: An Economic Approach to Institutional Change* (Tokyo: University of Tokyo Press, 1981 and Baltimore, MD: Johns Hopkins University Press, 1982).

Hayami, Yujiro, and Vernon W. Ruttan, *Agricultural Development: An International Perspective*, rev. ed. (Baltimore, MD: Johns Hopkins University Press, 1985).

Hayami, Yujiro, and Vernon W. Ruttan, *Agricultural Development: An International Perspective* (Baltimore, MD: Johns Hopkins University Press, 1971).

Ishikawa, Shigeru, *Essays on Technology, Employment and Institutions in Economic Development* (Tokyo: Kinokuniya, 1981), pp. 325–347.

Knight, Frank H., "Institutionalism and empiricism in economics," *American Economic Review*, Vol. 42 (May 1952), pp. 45–55.

Marx, Karl, *A Contribution to the Critique of Political Economy* (Chicago: Charles H. Kerr Company, 1913) [originally published 1859].

Nair, Kusum, *In Defense of the Irrational Peasant* (Chicago: The University of Chicago Press, 1979).

North, Douglass C., "A theory of economic change," *Science*, Vol. 219 (January 1983), pp. 163–164.

North, Douglass C., and Robert Paul Thomas, *The Rise of the Western World* (London: Cambridge University Press, 1973).

Olson, Mancur, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven, CT: Yale University Press, 1982).

Pincus, Jonathan J., *Pressure Group and Politics in Antebellum Tariffs* (New York: Columbia University Press, 1977).

Pincus, Jonathan J., "Pressure groups and the pattern of tariffs," *Journal of Political Economy*, Vol. 83, No. 4 (1975), pp. 757–778.

Runge, Carlisle Ford, "Institutions and common property externalities: The assurance problem in economic development," Ph.D. dissertation (Madison, WI: University of Wisconsin, 1981a), p. xvi.

Runge, Carlisle Ford, "Common property externalities: Isolation, assurance and resource depletion in a traditional grazing context," *American Journal of Agricultural Economics*, Vol. 63 (November 1981b), pp. 595–606.

Ruttan, Vernon W., "Cultural endowments and economic development: What can we learn from anthropology?" *Economic Development and Cultural Change*, Vol. 36 (April 1988), pp. S247–S272.

Ruttan, Vernon W., "Social science knowledge and institutional change," *American Journal of Agricultural Economics*, Vol. 66, No. 5 (December 1984), pp. 549–559.

Ruttan, Vernon W., and Yujiro Hayami, "Toward a theory of induced institutional innovation," *The Journal of Development Studies*, Vol. 20 (July 1984), pp. 203–223.

Schran, Peter, "On the Yenan origins of current economic policies," in Dwight H. Perkins (Ed.), *China's Modern Economy in Historical Perspective* (Stanford, CA: Stanford University Press, 1975), pp. 279–302.

Schultz, Theodore W., "Institutions and the rising economic value of men," *American Journal of Agricultural Economics*, Vol. 50 (December 1968), pp. 1113–1122.

Schultz, Theodore W., "Two conditions necessary for economic progress in agriculture," *Canadian Journal of Economics and Political Science*, Vol. 10 (1944), pp. 298–311.

Schultz, Theodore W., *Redirecting Farm Policy* (New York: Macmillan Co., 1943).

Stigler, George J., and Gary S. Becker, "De gustibus non est disputandum," *American Economic Review*, Vol. 67 (March 1977), pp. 76–90.

Thirtle Colin G., and Vernon W. Ruttan, *The Role of Demand and Supply in the Generation and Diffusion of Technical Change* (London Harwood Academic Publishers, 1987).

Whitehead, Alfred North, *Science and the Modern World* (New York: Macmillan, 1925).

Von Weizsäcker, Carl Christian, "Note on endogenous change of tastes," *Journal of Economic Theory*, Vol. 3 (December 1971), pp. 345–372.

Wiener, Martin J., *English Culture and the Decline of the Industrial Spirit: 1850–1980* (Cambridge: Cambridge University Press, 1981).

Wittfogel, Karl A., *Oriental Despotism: A Comparative Study of Total Power* (New Haven, CT: Yale University Press, 1957).

464

- SECTION 9 -

THE INFORMAL SECTOR: ISSUES IN POLICY AND PROGRAMS

PREFACE

From April 27 - 29, 1989, the Office of Technical Resources within the Bureau for Africa of the U.S. Agency for International Development (A.I.D.) sponsored a regional conference in Nairobi, Kenya for anglophone African participants that brought together 70 government, business, academic and informal leaders from 11 countries to discuss issues relating to policy and programs for the informal sector in Africa. For the purposes of the conference, the informal sector was defined as those persons who, although operating outside the law, are providing legitimate goods and services, as opposed to those who operate outside the law, but who are involved in criminal activities.

The informal economy is growing throughout the developing world, involving a vast market operating outside of government authority. Despite the size of this sector, it remains very poorly understood and is often regarded as an unemployed, or underemployed, sector with limited impact on the nation's economy. In fact, between 40 and 60% of the workforce and of GDP in most Third World countries, is in the informal sector. In most instances, these informals operate "illegally" because they cannot overcome the barriers which prevent their entry into the formal economy. To channel the energy of this expanding sector and to promote economic growth, reforms in the existing legal, administrative and political systems will be required.

To provide conference participants with a concrete example of the impact of empirical research and advocacy on reforms for informals, Mr. Hernando de Soto, Peruvian economist and President of the Institute for Liberty and Democracy (ILD) in Lima, Peru, was invited as keynoter. Mr. de Soto's groundbreaking research on the nature of and the constraints faced by the informal sector in Peru is the subject of his book, El Otro Sendero (The Other Path), published in Spanish in 1986 and in English in 1989, which has become an international bestseller.

According to Mr. de Soto, the existence and growth of the informal sector in Peru is due to the continuing presence of mercantilist structures in the political economy, which distort the functioning of the market and result in excessive regulations protecting privileged interest groups.

The Other Path does not present the informal sector as a solution, but as a symptom of an inadequate institutional and policy environment. It concludes that the high cost of formality results in severe economic losses: low productivity due to inefficient specialization, low levels of productive investment, high taxes which discourage new business creation and disincentives to technological innovation.

De Soto maintains that when laws and institutions ensure effective protection and enforcement of property rights and other contractual arrangements, transaction costs are zero, and markets are efficient. If the legal and institutional framework is inadequate, as in the case of Peru and most Third World countries, transaction costs are high, preventing market-led growth and inhibiting private initiative.

To assist in redressing the situation, Mr. de Soto and the ILD advocate change to open the economy to the informals and have developed major reform proposals

submitted to the government of Peru. Several of these proposals have been adopted, ncluding broad-based reforms to give property rights to informals and to ensure access by informals to the formal credit market.

In AFRICA, in the current climate of economic crisis, the informal sector is attracting growing attention. Governments are considering measures to simplify licensing and registration procedures and to decrease harassment of informals. Donors are considering means of intervening to assist this sector through credit, training and technical assistance. The World Bank is examining ways of promoting formal to informal linkages.

To assist in ensuring more effective actions in favor of the sector, this conference was designed to (1) identify policy measures which can promote African entrepreneurship within the informal sector; (2) examine effective programs to support informals; and (3) determine how advocacy programs may be established for pursuing needed reforms.

This report summarizes the presentations and discussions from the two and one-half day conference. Section One contains the opening addresses. Section Two contains the keynote address, commentary presentations and discussion on policy issues affecting informals. Section Three contains the panel presentations and discussion on policy reform in four African countries. Section Four contains the presentations and discussion on three program interventions to assist informals. Section Five includes the panel presentations and discussion on four approaches to advocacy for informals in Africa and the presentation by Mr. de Soto on ILD's advocacy program. Section Six includes the conference conclusions as they were debated and presented by members of four functional groups: government officials, researchers and economists, non-governmental organizations and the private (formal and informal) sector. Closing statements made by representatives from A.I.D.'s Bureau for Africa, Office for Market Development and Investment and Office of Technical Resources are also provided in this section. A list of conference participants and speakers is provided in the last section.

Deborah M. Orsini
Conference Organizer and Editor
Labat-Anderson, Inc.

June 1989

KEYNOTE ADDRESS:

HERNANDO DE SOTO

[Hernando de Soto is president of the Institute for Liberty and Democracy (ILD) in Lima, Peru. His major work El Otro Sendero (The Other Path), was published in Peru in 1986 (Editorial El Barranco) and in the United States in 1989 (Harper and Row). It became a best seller in countries throughout Latin America, with over 100,000 copies sold, and recently made the Washington Post's best seller list. Mr. de Soto studied humanities at the Universidad Catolica in Lima, and economics at the University of Geneva's Institut Universitaire de Hautes Etudes Internationales. He has served in many capacities, including Economic Affairs Officer in GATT, President of the Executive Committee of the Intergovernmental Council of Copper Exporting Countries in Paris, Managing Director of Universal Engineering Corporation in Geneva, Director of the Central Reserve Bank of Peru and Chairman of a private mining company in Peru. Since 1984, Mr. de Soto has been a member of the United Nations Committee for Development Planning. The ILD is a non-partisan, non-profit foundation which conducts an intensive program of research, publications, seminars and symposia to achieve its goals. It is extremely active in studying and proposing legislation to assist informals in Peru.]

I would like first to clarify that I am not an African specialist and I did not come here to advise you on the situation in Africa. I am a Peruvian citizen and I have written a book about Peru and its informal sector. Since that book was published, other studies have been conducted in the region, and I now know that I am speaking of a general situation in Latin America. Secondly, I am not a specialist on the informal sector. My concern is poverty and the access to wealth. Research on the informal sector appeared to be the best means of finding out why we are so poor in Peru.

According to the most optimistic estimates, the Gross National Product per capita in my country is $1,100, and we have been at that level for the last 20 years. In examining development literature, the implication was that Peruvians had not been able to outgrow poverty because there was something culturally or ethnically wrong with us- we were not entrepreneurs and we were not even prepared for democracy, which was why we needed strong governments. However, when the ILD examined the informal sector, we discovered they are very entrepreneurial and have very democratic organizations, which encouraged us to take a closer look at the sector. Our study was, then, first a means of learning about underdevelopment. Secondly, our study was not a traditional study of informality, that is, of the culture of the descendants of the Inca Empire, or of a class of marginals. We put aside all preconceived notions and found, in fact, that informals are not marginals, because they represent the majority of the population; they are not unorganized, because they have their own internal structures; they are not unemployed, because most are employed; they are not necessarily microenterprises because, when given a chance, they do grow. The definition which evolved from our research is that informal sector firms are those which use illegal means to achieve legal objectives, as opposed to those firms who use illegal means to achieve criminal objectives, such as the drug traders in Peru. Our challenge became one of measuring this sector, which was no easy task because informals try to flee the law. It required special empirical research methods and techniques.

After four years of research and talking with informals, we concluded that 62% of all manhours worked in Peru are worked in the informal sector and that 43% of our cities in Peru are informal. In the construction sector, 47% of the urban population of 21 million persons in Peru lives in houses built illegally, which are worth more than $18 billion. In all of Peru, seven of every 10 buildings today are being built outside the law. In the transport sector, 87% of the buses in Peru are informal. If taxis and vans are added, informals control 95% of public transport, with vehicles in Lima worth about $620 million. If spare parts, repair shops and gasoline stations owned by informals are added, they have a $1 billion industry in the capital of my country. In trade, we found there are 90,000 street vendors in Lima and that of 331 markets, 274 had been built by former street vendors. In totaling informal activities, we calculated that they contribute 38% to our gross domestic product and, in fact, that our GDP is 27% higher than that quoted in official figures. Also, the informal sector is much bigger than organized labor, which represents only 4.8% of the working population, while informals are more than 60%.

We then asked, why do the informals remain outside the law? The implied answer in books

on informality in Peru was that somehow, Peruvians wished to disobey the law. We decided first to look at the cost of the law for Peruvians- not for privileged Peruvians but for the poor. The formal sector claimed that anyone genuinely motivated to go into business could do so in 15 days with the help of a lawyer. To test this claim, we simulated the creation of a small clothing industry, consisting of two sewing machines in a workshop. Working 6 hours a day, one lawyer and four assistants needed 289 days to register that workshop, going through all the red tape required by government in order to operate legally. We conducted the same experiment in Tampa, Florida, and it took us 3-1/2 hours. We next looked at what was required to have government adjudicate land for housing purposes. Again, using simulation, we discovered that a housing association of 100 families would need to visit 52 government offices, fill in 207 documents and work 8 hours a day for six years and eleven months to obtain a legal adjudication.

We also found that, contrary to popular belief, informals pay taxes. In fact, the taxes they pay correspond to their contribution to GDP. They don't pay in the same way. There is no income tax, but they do pay considerable amounts for excise taxes, occupancy taxes for street stands, and property taxes.

When these results were announced in Latin America while my book was being promoted, we began to receive information that the same things were true in Venezuela, in Columbia, in Mexico, etc. We know therefore that this situation is not an unusual phenomenon in Latin Africa, and that it has more to do with government and politics than with culture.

As a result of our studies, we do not argue for doing away with laws, but for creating good law, as opposed to bad law. Good law, such as that protecting property rights, can result in immediate benefits for informals: our comparative study on two shantytowns on the outskirts of Lima showed that property values increase by a factor of nine when property titles are made available. Secure property rights also provide access to credit and insurance, neither of which is available to informals without property titles.

Microenterprise lending programs, which have done much to prove that informals are credit worthy, are supported by the Peruvian oligarchy because that means informals get microcredit, while the oligarchy keeps the big credit. To get big credit, you must have land reform. Land reform means giving individuals private property titles. The lack of secure property titles in the Third World goes a long way towards explaining credit, towards explaining horizontal rather than vertical growth of cities, towards explaining poverty.

Without access to good law, informals are deprived of all the infrastructure on which developed economies depend: courts, contracts, limited liability, pooling of resources, insurance policies, enforceable guarantees, bankruptcy law, protection of intellectual rights, patents, royalties, etc.

This lack of good law also affects the formal sector, through such more sophisticated legal instruments as differential control and exchange rates, indirect taxes and surcharges on imports, direct taxes on imported goods, licenses, quotas, lists of authorized goods, advance payments on imports, exclusive and inclusive subsidies, tax reimbursements, direct investment regulations and exchange controls. In fact, most formal sector firms feel it is more important for managers to be close to government than to their plants since the high transaction costs come from government.

It is not only the informals who flee the law. Formals also flee the formal sector: flight of capital and brain drain are the ways formals have of fleeing the state. Poor people flee to the informal sector, rich people go North. Everyone leaves a state that does not produce good law.

To determine why we had such bad laws in Peru, we looked at how laws are made. We counted, for the first time in Peru, the number of rules the central government makes. We found that in one year it makes 27,000 rules, or about 111 rules per working day, of which 99% are made by the executive branch of government. This means that only 1% of Peruvian rules are made with representatives of the opposition present.

To determine where Peru had gone wrong in its law-making process, we studied developed countries and found that in the Western world, the executive branch of governments are accountable to the people. Rules must be brought out according to established procedures. In the United States, rules are produced in draft and must include a cost-benefit analysis. This is published, comments are solicited and public hearings are organized. In other developed countries, other systems

apply, but all involve government accountability. We also found out that developed countries provide access to public information. In the U.S., any citizen can ask to have the documents on which a rule was based. In Peru, this is forbidden for reasons of "security" and "national interests". In fact, in Peru, laws are totally divorced from reality. Ergo, the informal sector. Ergo, poverty.

We discovered, however, when we looked at history books of Western economic development, that just 200 years ago, this was the same way the Western world was governed. Going into business required a charter from the king. The system was a mercantilist one in which politics and business were tightly united. Informals lived in "suburbs" and were persecuted. Formals subcontracted to informals under the "putting-out system", putting out production to cottage industries.

This environment was very similar to that in Peru today. The informal sector is, in a way, equivalent to the birth of the Boston Tea party-people who felt they did not have the same economic rights as formals and who wanted some kind of participation, regardless of their political status.

This is why we believe that the informals are more than just the sector of microenterprise. They are a constituency for change. If we can open our country and make it a viable democracy, then we can hope to become a Hong Kong. If we don't, if we repress it, we will get Vietnam.

In Britain, when the large migrations to the cities began, the British gradually opened up the system. They began registering property, calling for municipal elections and a more powerful parliament, making credit available to everyone. They made a peaceful transition from mercantilism to an open democracy. In Russia, the opposite was true. The Czar insisted on the old traditions and he got a violent revolution, leaving the argument of enfranchisement in the hands of radicals, rather than in those of moderate people.

In Latin America, democracy and entrepreneurship have not failed– they have not been given the same chance as in the West. This indicates the need for empirical research, but not from existing books– none of the books in Peru told us the things we found out from our empirical research on informals. You must discover the informals, by talking to them. We found out that their number one enemy is the law. We found that informals are not seeking handouts, but opportunities, and that there is nothing that democracy and equal access to opportunities will not cure in the case of Peru and Latin America.

DISCUSSION

Mr. de Soto's remarks were followed by a lengthy discussion period. Participants readily confirmed that many similarities exist between the situation in Peru and that in Africa.

Mr. de Soto was asked what reforms had taken place in Peru since the publication of his book. He answered that reforms had occurred even before the book was out, since ILD's procedure is to conclude every study undertaken with a legislative or regulatory proposal to change the status quo. The instrument used to push for reform is a public hearing system known as "Everyone's Balcony" (El Balcon de Todos). This appellation is based on the practice of the President of Peru of speaking to the people from his balcony. To have the people speak to him, ILD developed "Everyone's Balcony" in which informal sector representatives as well as public and private sector leaders are invited to public hearings on proposed reforms. ILD consults with the informals on the legal texts of the reforms from beginning to end. Once the texts are produced in draft, they are published in official newspapers. ILD then obtains signatures in support of the proposals and publishes the number of signatures, duly notarized, in the newspapers. Their first reform proposal was in 1985. ILD obtained 300,000 signatures and as a result, private titling became law. ILD has also helped pass laws regarding accessibility of information, administration of adjudication, debureaucratization and deregulation. The most recent reform is that of the formal credit system, allowing people with scarce resources access to credit. Most of these reforms are recent, so there is little information on their economic impact as yet, but the first step of changing the legal environment has been taken.

Another participant asked Mr. de Soto to comment on the need for planned change, as opposed to uncontrolled change, which he felt would occur if informals were left to their own desires. Mr. de Soto noted that half of his book deals with the laws and institutions developed by the informal sector, termed extralegal norms. ILD has studied these and

discovered that each new informal shantytown operates by laws, with voting representation of each block. All the production of rules is done openly and democratically and the community plans their use of public goods. ILD has found that there is middle ground between what people thought was mushrooming and what government thought was planning—there is such a thing as "planned mushrooming." He noted that anywhere in the Western world, where plans work, the plans are not the privilege of the few, but are susceptible to review, comment and adaptation by the people. What is needed is a system of participatory government and democratic rulemaking in which the plans respond to the needs of the majority.

Mr. de Soto was asked how the legal and institutional environment had impacted on the development of countries such as Korea and Japan. He explained that he was on his way to Japan to study just that question, but his understanding from the information available to him to date is that there are two models in Asia. In certain countries, such as Japan, there is a system of accountability, although it is not as open as the Western model. Decision making is done through a multi-layered process of consensus building. In other countries, such as South Korea, economic development has occurred under authoritarian regimes. However, one must ask how long these economies can grow without an open, democratic economy. It appears obvious now that from South Korea, to Taiwan, to Singapore, further growth will require opening the country up. Once people are wealthier and more sophisticated, it is difficult to stop democracy. He noted that while the democratic model of pluralism and general consensus is preferred, he does not deny that other models can produce growth.

The next question was whether there is any evidence that change in regulations or laws could work against informals, in terms of markets and profitability. Mr. de Soto responded that once laws are restructured to ensure operation of free markets, certain informal sector entrepreneurs would probably cease being entrepreneurs. Certain of today's entrepreneurs would become tomorrow's employees. As the informals become formalized, through good laws, the tendency would be towards concentration of activities, with economies of scale, fewer entrepreneurs and more employees. In that sense, these changes would work "against" informals, but he stressed that informality is not necessarily a model to follow.

Another participant asked Mr. de Soto to share a specific example of his work with informals. Mr. de Soto described his work on Third World debt and structural adjustment, which found a direct application in October 1988 when the bus and truck drivers of Peru went on strike following the government's refusal to increase their maximum allowable fare after a currency devaluation. The striking drivers, 360,000 strong, paralyzed the country. ILD was asked to mediate between the drivers and the government. Working with ILD, the drivers agreed to submit a proposal to the government asking, in lieu of increased fares, for a lowering of the costs of inputs. The government agreed to liberalize the conditions for sale of spare parts, tires and vehicles to the public transport sector by lowering import tariffs from 180% to 15-20%. This program was adopted by President Garcia, who had become famous for refusing the structural adjustment program of the International Monetary Fund. However, the Goodyear tire company, citing defense of national industry and of Peruvian labor, sought an injunction to stop imports of spare parts, tires and vehicles. ILD went to court for the bus and truck drivers and won against Goodyear. ILD refuted on television the arguments of Goodyear, explaining that Goodyear employs only 1000 persons while the transport business employs 360,000. In addition, 400,000 other persons use tires and 5 million people use buses and trucks. ILD further noted that the tires manufactured by this national industry cost two and one-half times more than what imported tires cost.

This situation, which Mr. de Soto calls structural adjustment from the bottom up, was described in a letter to the U.S. Secretary of Treasury Brady. In that letter, ILD argued that the informal sector is a constituency for change and that structural adjustment is acceptable to developing countries, provided the structures being adjusted are those which help poor people.

Mr. de Soto was asked if a manual existed on how to set up institutes like ILD in developing countries. He answered that under a new grant from A.I.D., ILD has accepted, as of 1990, to organize courses in Peru for people from

abroad. Subsequently, some type of manual might be developed.

The final question dealt with linkages between formals and informals. Mr. de Soto indicated ILD has found that the separation between the formal and informal sectors is not as clearly defined as is thought and that in fact they are fairly well integrated. Groups which are mainly informal, e.g., those in the streets—vendors, transport people, construction people, do subcontract with formals both to provide inputs and to ply formal sector wares.

Dr. Donald Mead
Michigan State University

[Dr. Mead is an agricultural economist at Michigan State University in East Lansing, Michigan. He is part of the core staff of the Enterprise and Employment Policy Analysis Project, funded by AID's Bureau for Science and Technology. His paper was prepared under the auspices of that project. He has consulted extensively in Africa on policy reform issues, particularly as regards small enterprises. He is the author of several scholarly works on policy reform in the Third World].

In my presentation I wish to address specific policy issues from the African perspective. It is well known that the modern sector of the economy in Africa, by which I mean that part which has access to special benefits, has been growing very slowly and, as a result, people have been forced to seek employment in the rest of the economy which does not have special access, which is unregulated and which is known as the informal sector. While some of these activities are "dead end" ventures, others are very dynamic, with great potential for growth. To promote this growth, I believe we should concentrate on two goals for policy: to remove constraints and establish an environment which provides incentives for producers to innovate; and to disseminate to all types of producers information about technologies and markets and products, while broadening their access to inputs in order to strengthen their capacity to respond to opportunities.

I would like to examine those two goals in two sectors. The first is agriculture which, to me, is the starting point of all work in Africa. There is considerable liberalization going on in the agricultural sector, which means basically getting the government out of price controls and out of marketing of both inputs and outputs. How do informals relate to that? Before governments began moving out of monopolies, their inefficient distribution systems were paralleled by private distribution systems which were illegal. Liberalization now means that these activities are being transferred from the informal to the formal sector. The country in which this has been best documented is Mali. Those who have researched the effects of liberalization in Mali have found that while farmers have benefited from liberalization, their capacity to respond to the new opportunities has been severely limited by restricted access to improved technologies, to input supplies and to supporting institutions.

The process of liberalization therefore involves fundamental reallocation of roles between public and private sectors. If liberalization is to lead to improved market performance, it is not enough for the state to withdraw from certain activities, like monopoly marketing systems. The state must also assume other responsibilities, like better public information systems and improved credit markets to allow private traders to respond to new opportunities. The second sector is that of rural non-agricultural productive activities. Here we must ask how the increase in agricultural production produces multiplier effects. The extent of these multiplier effects is a function of the policy environment and of the capacity of those nonagricultural producers to supply the demand that comes forward. In Rwanda, we noted that when poor farmers get extra income because their agricultural production has increased, their first priority is to improve their housing. When they put a new roof on their house, they have two choices: to buy corrugated metal sheets from a local factory that is highly protected and subsidized, or to buy ceramic tiles made by dispersed rural tile makers who cannot compete with the protected and subsidized corrugated sheet manufacturers who import their raw materials and benefit from an overvalued exchange rate. With a more balanced exchange rate, tiles would be cheaper, but even then the tile producers would need technical assistance to produce a standard quality of tile and to be able to evaluate structural effects when the heavier tiles are used on roofs. In summary, macropolicy changes are needed in the foreign trade regime and technical assistance is needed for the tile manufacturers.

SECTION VI

CONCLUSIONS

Introduction	Warren Weinstein Director Office for Market Development and Investment Bureau for Africa A.I.D Washington

Presentations:

Group 1:	Government Officials
Group 2:	Researchers and Economists
Group 3:	Non-governmental Organizations
Group 4:	Private Sector (Formal and Informal)

Closing Statement	Fred O'Regan Office for Market Development and Investment A.I.D., Bureau for Africa

Closing Statement	Deborah Orsini for Office of Technical Resources A.I.D., Bureau for Africa

Warren Weinstein
Africa Bureau, Office for
Market Development and Investment

These conferences have been very useful to those of us from A.I.D. They have begun a process of dialogue which should be continued between yourselves and the USAID missions in your home countries. We will pursue them between our missions and A.I.D. Washington. This will allow also for more informed dialogue with the government. If what we are all saying is based on what people in the country are identifying as requirements, then the officials in the various countries will also begin to see the interest. It goes back to what Mr. de Soto said, which is if you want to change things, you have to go out and do a fair amount of empirical analysis, to find out what the facts are, what people need and what they will support. Those facts and those opinions can be presented to government, which can then no longer fully stay quiet. Our conclusions will not end at this conference, but will continue in action plans upon your return home. We look forward to your comments and advice. Thank you.

Summary Statement by Group 1 Government Officials

Our group began by defining the origins of the informal sector. We agreed that entrepreneurial activity existed in Africa well before colonization. Under colonization, rules and regulations were made that excluded indigenous entrepreneurs from what came to be known as the formal sector.

Our group concluded that the laws and policies which exist were designed to protect formal business. Their effect was to institute constraints to indigenous entrepreneurs, forcing them into the informal sector.

In discussing these laws and policies, our group noted they fall into several main areas: legal, political, financial and markets. The legal area includes elements such as licensing, registration, land tenure and access to property. The political area involves questions of accountability and the creation of lobbies. The financial area concerns primarily access to credit. Market concerns include location and transport.

Our comments on these areas are the following:

On the legal front:

1. Red tape, licensing and registration must be carefully examined, in order to deregulate.

2. Questions of land distribution and tenure must be examined to attempt to find a practical solution. Our group recognized that these questions are complicated due to values derived from the past and to the relationship to the political process. Land distribution cannot take place quickly because land must be bought and very few persons have money or access to money. All of these elements tend to perpetuate the status quo. Nonetheless, we must push to facilitate the obtaining of titles and the transfer of property.

On the political front:

1. Governments are not accountable, partly because of values our leadership internalized as they grew up and partly because of the diffuseness of the informals themselves. This situation must be improved.

2. The lack of cohesion among informals stands in the way of their realization of their power as a group, which, as the majority population in most countries, could be considerable. Informals must be aware of the need to incorporate themselves. Lobby groups among informals are needed. They will have to build mechanisms to obtain advice and support from legal organizations.

3. Governments should serve as a catalyzer in efforts to assist informals, but there is no need for more ministries and departments since that only produces controls.

4. Only an organization for informals and by them will lead to empowerment. The organization should be based on an African model, participatory and consultative, and not dictatorial like the governments that have evolved.

5. The question of communications also influences informals' potential power. They do not control the media and often cannot read what is published in newspapers, in any event.

On the financial front:

1. The key question is access to credit, usually complicated by lack of collateral which persons who have been excluded from the system for

a long time do not possess. Collateral requirements should be decreased. Efforts like those underway in Senegal to promote character-based lending should be increased.

2. Many in our group felt that interest rates are not a factor which inhibits lending.

3. Taxes should be decreased by reducing duties on products. Tax incentives should be studied.

4. Subsidized credit should be limited since resources are so scarce.

5. Informals must establish informal credit organizations to help themselves.

On the market front:

1. Informals may develop good products but they lack the ability and knowledge to organize themselves to market those products. Access to markets should be facilitated.

2. Informals are often not allowed near the markets where their products could be bought.

3. Many informals are unable to find transportation to bring their products to market.

4. Informals need their own marketing organization for selling products. There should be special markets for their products, as well as fairs and bazaars set up periodically for them.

On the question of advocacy, the group noted that the near term objectives of any advocacy program should be to abolish excessive regulations that are not responsive to the needs of informals.

Our group felt that the best advocacy programs will be those mounted by the informals themselves, with assistance as needed and available from NGOs, government organizations and local authorities. These organizations must communicate better with informals.

To lobby for their interests, informals must consolidate their power and overcome their diffuseness. They must learn how to use the political system.

Summary Statement of Group 2 Researchers and Economists

Our group agreed that existing laws concerning private enterprise have minimized growth. Diagnostic and empirical research is needed to determine the exact constraints. We must do away with bad laws which have evolved, due usually to poor information. Researchers must provide good information.

In the area of policy reform, we felt an independent research organization which could develop various research agenda, either regional or national, should be established.

We agreed that existing program interventions for informals are not effective. They are not based on needs assessments. We must look at the real constraints.

Existing support measures have either limited or no participation by the key players. Along with the informals, banks, NGOs, churches, political parties and ministries should all be involved.

The support institutions are not of the right type. Since their programs will be judged on the degree of development of informals, support organizations tend to do too much for informals in order to move faster.

Our group felt that government support institutions are the least effective. NGOs are better because they are more flexible. Churches in particular have had long term experience with this sector.

In the financial sector, commercial banks will always be reluctant to lend to informals, but they should attempt to identify the positive aspects of the sector, especially group lending, and help organize those groups to provide the necessary collateral.

For advocacy, there is a tremendous lack of information for policy making. It is important to build research efforts to provide better data to develop better policies, similar to the work in Peru.

Summary Statement by Group 3 Non-Governmental Organizations

On the question of policy, our approach was similar to that of Group One, i.e., we felt most of our laws are based on inadapted British and Indian laws. Many of the bylaws have not changed over time.

In many cases the administrators and people in government offices take advantage of some of these laws because it benefits them. Many informals lack knowledge of what these laws are.

Our group felt strongly that governments must decriminalize informals, and support informals as legitimate entrepreneurs. Rather than prosecuting informals, governments should educate.

Registration must be simplified and decentralized and explained so that informals can make the transition to formality. We also need to educate informals since they don't know how to register and fear the process. The government should take a mass media action to inform informals on how to register their companies.

Licensing should be decentralized and some licenses should be abolished. particularly since licenses are costly to administer. Certain standards could also be relaxed, such as permanent structure standards. If these standards were eased, corruption would be less and informals would not have to pay bribes.

Most of our group felt that all businesses should pay some tax, perhaps a small, scaled tax. By paying taxes, informals will gain credibility and will then have a platform to make additional requests.

Informals need to form small credit groups among themselves, as credit is a major problem and access to financial institutions is limited. Banks should agree to devote some resources to development. Character lending should be pursued. As in agriculture and housing, the government could mandate that a certain percentage of loan portfolios must be for informals.

Certain sectors have no market problem while other need assistance, especially for innovative products. NGOs or governments should assist by holding fairs or linking them with other sectors of the economy.

In the program area, we strongly agreed that NGOs have a lot of isolated experiences which they have been keeping to themselves. This knowledge must be shared.

Also, it is critical that NGOs consult more often with the informals, rather than assuming that we know what they think. We must find out the specifics of what problems they have.

NGOs should meet to determine what information they have already and then bring in the informals and validate or correct our conclusions about their constraints. We can then move to involve other parties.

Programs have been most successful where they are conducted by donors through NGOs and directly involve the recipient groups. Any program that is imposed does not work. NGOs in Kenya have learned a lot, but their performance from the standpoint of cost/benefit is not impressive. There is room for improvement in NGO management style. They must be more businesslike and must scale up their operations. Certain activities should be spun off and others emphasized.

Donors need education also. Their expectations are too high. They must understand that there is room for mistakes in this first generation of programs.

On advocacy, NGOs must network and begin to do research. They should move away from maintenance of their ongoing activities and into the policy arena. They should assist in bringing together government, NGOs and informals.

Summary Statement by Group 4 Private Sector

On policy reform, we have agreed as a group that we will take the three steps as recommended by Mr. de Soto, as our guiding tune. There must be empirical studies undertaken to know what we want to change before we can understand how to change it. We must know what the strengths and potential of the informals are. And we must mobilize the informals to ask for change.

-476.

On registration and licensing, we felt that laws must be simplified. No bureaucracy should try to impede entry into the economic mainstream by informals. Tax laws are much too complicated. When laws say you must pay an occupancy tax to use the street, they start by giving you paragraphs and paragraphs which complicate everything for informals. Informals don't have the time or the literacy to understand all of this. Simplification will lessen the number of unwitting criminals.

On credit, government could use its big hand to help, be proactive and reach out. The formal sector, including the private sector, should reach out to informals. Stokvels and other schemes are possible solutions. Innovative approaches to collateral are needed.

As to programs, interventions are still new to informals and must be carefully studied. Donors tend to reduce their assistance to insults. They throw money at a problem and then turn their back on the recipients. They must know why they are helping. We need skills more than funds. It was our impression that programs are often based on First World standards. Local needs must be considered, with direct consultation with the informals.

On advocacy, we were very impressed by the presentation by Group One, which did much to explain to us how government officials see their role. Governments must take into account the needs of informals.

Links between formals and informals are needed, along the lines of a business council, but not to clear formal sector consciences or to stroke their egos, but to be genuinely involved. They must look upon informals as a supplement to their activity, not as a competitor. The emphasis must be from the bottom up.

Our message to this conference is don't do things for informals, but with informals.

CLOSING STATEMENT

Fred O'Regan
Office for Market Development and Investment

I would like to summarize the statements made here today and the comments made by many of you over the course of the last two days.

I think you'll agree that there has been a great richness in the ideas shared here. I will mention those that particularly impressed me. One is the background statement that we could argue that the informal sector is really legitimate African enterprise that was interrupted by colonialism.

In the policy area, there is a number of interrelated things: land entitlement and incorporation, coupled with the fact that there are too many overly complicated regulations. There seems to be agreement that credit policies simply limit access to credit, and that interest rates should be deregulated. On the markets side, certain pricing policies have wiped out or continue to constrain the development of whole sectors of production.

Decriminalizing informals is important. The idea of a simplified tax that would remove harassment and corruption merits attention.

In terms of program interventions, those who have been involved in this first generation of interventions have concluded that a tremendous amount has been learned about the mix and intensity of credit and marketing assistance. An institutional base has been laid. For the second generation of interventions, we need greater efficiencies, more people reached and a stronger commercial mentality in program management. Donors must be patient and accept that we learn from failures. Also, we must recognize that flexibility in financial instruments and administrative controls are needed if we want to get close to this sector. A different type of relationship with informals is critical, as Mr. Muchiri pointed out.

The establishment of informal sector credit programs through informal sector organizations is clearly an idea whose time has come. NGOs will have a role to play here, as will other implementing organizations.

On the advocacy side, organizing through informal sector organizations seems to be the theme that has cut through what has been said. Informal sector representatives are obviously underrepresented at this conference, and it shows that all of us who have been working in this area probably don't have as good a network of contacts at that level as we should. What I would call action research seems to be the method that is coming out here. That clearly follows what Mr. de Soto emphasized.

NGOs and informal sector organizations should come together first to take the first steps to

find out what information is there. There is a lot, but it is disaggregated at local levels in different organizations. We must consolidate that information and then can move forward with advocacy.

The underaccountability of governments has gone past its time. Governments must catch up and open up participation in the decision making process.

My last point is it is clear that none of the above activities can happen in isolation. Programs must inform policies. The foundation that has been laid by NGOs and the contacts in the informal sector. At the same time, research that has been done is informing programs. It is better understood that constraint removal has to be integrated into program interventions. Lastly, networking among different organizations is critical.

In summary, a truly holistic approach involving networking, research, dialogue and continued program support, is needed to lay a base both for policy reform and for interventions. I would like to say that I have learned a lot from these conferences and I thank you for your participation.

CLOSING STATEMENT

Deborah M. Orsini
for A.I.D., Africa Bureau
Office of Technical Resources

I would like to summarize what is intended as follow-up to these conferences. We would first like to ask each country delegations to draft a post-conference statement on planned follow-up activities in their home countries. These documents should be transmitted to the local USAID mission and to our offices in Washington. Second, the A.I.D. Office of Technical Resources and the Office of Market Development and Investment will be working together to determine what field assistance will be provided in several areas to further projects and research in the area of policy and programs for informals. These activities may include follow-on conferences in targeted countries, technical assistance teams to look at project design, implementation and evaluation, particularly to promote the more "holistic" approach to interventions to which Fred O'Regan referred. Finally, we will be evaluating means of accessing ILD's expertise in Peru to support independent research activities on the African continent.

I believe that we have begun an excellent process of dialogue and networking during this conference. We will seek means of maintaining this network and exchanging information and documentation over time. We would ask that you do the same among yourselves, both on a national and a regional level, and with our offices in Washington. To this end, we are providing each of you with a complete list of participant names and addresses.

I would again like to take the opportunity to thank each of you for your very active participation and to wish you every success in your continued efforts to promote change in your respective countries.

SECTION VII

List of Participants and Speakers

AID Washington:

Mr. Warren Weinstein	AFR/MDI
Mr. Michael Caughlin	AFR/MDI
Ms. Catherine Gordon	PRE

LABAT-ANDERSON, Inc.

Mrs. Deborah Orsini	Private Sector Training Coordinator
Mr. Richard Everett	Assistant Training Coordinator

Speakers

Mr. Hernando de Soto	Institute for Liberty and Democracy (ILD), Peru
Dr. Donald Mead	Michigan State University
Mr. Fred O'Regan	Community Enterprise Corporation, Washington, for AID/AFR/MDI
Mr. Robert Ocran	Managing Director, Mankoadze Fisheries, Ghana
Mr. John McKenzie	Kaolack Project, Senegal
Dr. I. A. Onyango	Senior Planning Officer, Ministry of Planning and National Development
Mr. Albert Mutua	Deputy Director, Kenya Rural Enterprise (REP) Project
Mr. Christopher Aleke-Dondo	Kenya Rep Project
Mr. Wilson Muchiri	National Chairman, Kenya Small Traders Society
Ms. Nancy Wilson	Program Officer, Ford Foundation, Kenya
Mr. Ephraim Kamuntu	Regional Policy Advisor, World Bank, Nairobi

Special Guests

Ms. Eleanor Constable	U.S. Ambassador to Kenya
Mr. Okiki Amayo	Assistant Minister for Technical Training and Applied Technology
Mr. Peter Eigen	World Bank Resident Representative, Kenya

Botswana

Ms. Gloria Tebogo Nkwe	Private Consultant
Mr. V. K. Selato	Assistant Director of Integrated Field Services, Ministry of Commerce and Industry

Burundi

Mr. Larry Dominessy	USAID Burundi

Ghana

Dr. Edmund Abaka	Director, Natl Board for SSI's
Mrs. Comfort Engmann	Chairperson, Women's World Banking

Kenya

Mr. George Donde	National Council of Churches of Kenya
Mr. Alfred Amisi	Partners for Productivity, Kenya
Mrs. Elvina Mutua	Tototo Home Industries
Mr. Sebastian Nkonge	Isiolo, Catholic Diocese
Mr. Jacob Mwangi	Voluntary Agencies Development Assistance (VADA)
Mrs. Louisa Owiti	General Secretary, YWCA/Kenya
Mrs. Martha Menya	Women's Enterprise Development
Mr. John Makilya	Technoserve Kenya
Mr. James Philip Mutiso	Ass't Director, Jua Kali Training and Applied Technology
Mr. Joseph Karau	Deputy Divisional Manager, Informal Sector Project, Kenya Industrial Estates
Ms. Cecilia Murioki	ILO - SDSR Project
Ms. Victorine Kpohazounde	Program Developer, ACCOSCA
Mr. Joachim Schwach	Credit Management Advisor, KIE Informal Sector Project
Mr. James Tomecko	German Corporation for Technical Cooperation (GTZ)
Mr. Jonathan Campaigne	Council for Intl Development/Kenya
Mr. Don Greenberg	REDSO/ESA
Ms. Holly Wise	USAID Kenya
Mr. Stafford Baker	USAID Kenya
Mr. Justus Omolo	USAID Kenya

Mr. Godfrey Cherono	Peace Corps Kenya

Nigeria

Dr. Ademola Oyejide	Professor, Department of Economics, University of Ibadan
Dr. T.O. Fadayomi	Director, Nigerian Institute of Social and Economic Research

Somalia

Mr. Nur Mohamed Gas	General Manager, Berbera Cement Agency, Ministry of Industry
Mr. Abdullahi Mohamed Yahie	Director of Human Resources Development, Min. of Natl Planning
Mr. Said Mumin Mope	Deputy Director, Technical Dept, Min. of National Planning

Republic of South Africa

Mr. Israel Skosana	Deputy Managing Director, Get Ahead Foundation
Mr. Lawrence Mavundla	Head of African Council of Hawkers and Informal Businesses (ACHIB)
Rev. Michael Mjekula	Minister of Ethiopia Church, Secretary of Natombekaya Mgubas 1 Foundation for Social Development
Mr. Jeffrey Kleinsmith	Managing Editor of People's Express, grassroots newspaper, and of "Black Book", directory of black businesses
Mr. Jabu Mabuza	Communications Manager of SABTA South African Black Taxi Association
Mr. Ernest Melville Bergins	Private Sector Consultant

Swaziland

Mr. Roger Carlson	USAID Mission Director
Mr. Max Gonson	Private Sector Officer, USAID Swaziland
Mr. Dumisani Mavimbela	Undersecretary, Ministry of Commerce, Industry and Tourism
Mr. Derek Von Wissell	Private Sector Consultant

Tanzania

Mr. Damas S. Dandi	Executive Director, Tanzania Youth Development and Employment Foundation

Mrs. Hilda Mafwenga	Head of Finance and Marketing, Suwata, Economic Wing, UWT, National Women's Organization
Zambia	
Dr. Moses Banda	Chief of Research and Development, Zambian National Commercial Bank
Zimbabwe	
Ms. Sherrie Shereni	Economist, Reserve Bank of Zimbabwe
Mr. Mervyn Ellis	Chief Economist, Standard Chartered Merchant Bank
Mr. Macmaster Kwaramba	Project Officer, Zimbabwe Development Bank
Mr. Phineas Dangarembizi	Economist, Old Mutual; representing Zimbabwe Chamber of Commerce
Dr. L.E. Munjanganja	Deputy Secretary, Min. of Manpower Planning, Employment and International Organizations
Ms. Margot Biegelson	USAID Harare