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Structural Adjustment and Informal Sector
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Structural Adjustment and Informal Sector

Presentation by Mr. Hernando de Soto

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at Microenterprises Conference, Washington, D.C. June 6-9, 1988

I will be addressing the subject of structural adjustment and the informal sector. My institute in Peru has done a lot of research on the legal constraints that refer to what we call informality, i.e., to say the operation of basically illegal enterprises who have legal objectives. The informal sector is a euphemism for the illegal sector. We should point out, however, that their objectives are clear and honest as opposed to say those of the drug trade.

Some time ago in a conference I attended, there was a paper that contrasted structural adjustment which is something we've heard a great deal about this morning, with the microenterprise or the informal sector. They used the idea that structural adjustment, which essentially means dismantling market distortions, would permit growth in a developing country. It means replacing pervasive government regulations and laws, and in this sense, they found that too much attention given to the microenterprise or informal sector drives attention away from good structural adjustment. Helping the informal sector meant, in the view of the presenter of the paper, concentrating resources on precisely those sectors of the economy that were the most unproductive in their view--the small enterprises which have no economies of scale and that pay low wages. Small firms, they argue, simply are programmed to survive and stay small.

You won't be hearing much about that I suppose in a conference like this. On the contrary, you will hear the most agreeable comments that we heard this morning from the heads of these three international organizations

in the sense that more attention is being paid to microenterprise and the informal sector. In fact, if you look at the budgets of the different inter-government organizations and you look at the budgets of national governments, the microenterprise sector is still a poor relative. As a matter of fact, it is generally labelled at the moment where you have to take hard decisions, as glorified charity work. In Peru, the total amount of credit that goes to the informal sector of total national credit is only about 0.3 percent, 1/3 of a 1 percent. So, no matter if there is a lot of lip service given to it, at the end, when government and political decisions are taken, the consequences are that micro-credit, which everybody applauds, is really the poor relation.

I would like to argue to you today that there is a political case to be made, for helping microenterprises. It's not only that microenterprises should be taken into consideration by those people that make structural adjustment, that go for structural transformation, that are the advocates of policy reform, but that in fact the informal sector is the solution, is the missing link, that will help policy adjustment to take place. If you actually think about policy adjustment or structural transformation--at least in a country like mine, Peru--it has not had much success. I think that the informals are crucial not only to understanding why structural transformation proposals that come from the West are not successful in developing countries, but in fact they are crucial to making sure that structural transformation is politically viable. To do this I have to bore some of you, who have already read or heard on other occasions those basic statistics but this is unavoidable; also, I will talk to you about a project that we have recently promoted in Peru which is one of structural transformation and that is based on the political presence of the informal sector in my country.

The first that we found out, and I think it's very important in Peru, is that the informal sector is very large. It is, as somebody mentioned this morning, at least 50 to 60 percent of the man-hours worked in Peru. Our calculations indicate that's 47 percent of the population on a permanent basis, and if we take man-hours it's about 61 percent of these man-hours. Moreover, it's 38 percent of gross domestic product. In other words, it's a majority of Peruvians and accounts for close to 50 percent or almost half of the gross domestic product. In housing concretely, we found out by counting the homes, one by one, that those that had been built informally, i.e., to say outside existing regulations and the law, had a value of \$9 billion and constituted 47 percent of total buildings in the City of Lima. In fact, today, of every 10 homes being built in Peru, 7 are being built informally and only 3 formally. So, it's a growing phenomenon. We also found by looking at the public transport system that if we include taxis, 95 percent of Peru's public transport system is informal. If we don't include taxis and vans, 87 percent of the buses in my country are informal. They operate at no deficit, of course, while the state corporation that only manages 5 percent of public transport operates at a yearly deficit of about \$12 million.

The street vendors who compose a rather large amount of the sales force of Peru--60 percent of all sales take place through street vendors--continually informed us that their desire was to move toward markets. So, one of the things we did first was spend a year counting the markets in the City of Lima, combing the streets one by one, and we found that there were 331 markets, or producer markets if you wish, with stalls, running water and electricity and a sewage system, of course, and it turned out that these markets--built since the time of the Spanish conquest--57 had been built by the states and 274 by the informal sector. So, we can see that the informal sector is a strong component once you start counting it and you start viewing it as a sector which operates outside the law--mainly through microenterpris-

es. It's a very large part of the economy and must be taken into account. You cannot do structural adjustment, you cannot do policy transformation without taking into consideration that part of the economy.

Now, the second thing that we asked ourselves was: "Why does the informal sector work outside the law? Why doesn't it do all these marvelous things that it's doing within the law and take advantage, for example, of formal credit, or take advantage of property rights, or take advantage of any of those facility elements of the law which are crucial to the growth of business?" And the reply we found was it was because of the structures themselves, because of the legal system itself. To find this out, we didn't read it in a textbook, but we went out and simulated the incorporation of a small enterprise. One of the first trials we did, which most of you I'm sure are familiar with, is set up small workshop in a district of Lima, with two sewing machines and asked a lawyer and his four assistants to actually go through all the red tape that was necessary to make those two sewing machines operate legally. Working 8 hours a day, with 4 assistants and a stopwatch, it took 289 days to register the firm. When we did the same experiment in Tampa, Florida, it took us 3-1/2 hours and we've just completed it in New York and it took 4 hours, which means that a Peruvian entrepreneur, to start off a small clothing workshop, has to work 700 times more than a U.S. entrepreneur just to get started if, provided, of course, he's read our study report which he probably hasn't.

In terms of housing, you know that in many Latin American countries at least half of the buildings are those that surround the cities. We call them in Peru--these legal buildings or informal buildings--"Pueblos Jovenes" or young towns. They have different names in other countries. They are called favellas', I believe, in Brazil and "ranchos" in Venezuela. Well, we also ask ourselves why these people that could, of course, not live--given the

property values--in the center of town did not simply have sand dunes allotted them. I mean the state after all has procedures for handing over government land to people who need it, and we found out again by simulating in part and by putting together "red-tape" histories that it takes, in average, a person that is the head of a housing association with about 100 people 6 years and 11 months working 8 hours a day to complete 207 bureaucratic steps and visit 52 government offices. This, of course, explains to us why in 1985, in Lima alone, there were 282 invasions of land and only 3 legal adjudications of land. It wasn't that Peruvians or Latin Americans, favor doing things illegally, it was that the law had enormous costs, especially for poor people. In terms of actually helping to build produce markets, we found that between the time a group of street vendors in the streets of Lima decided they are going to build markets and the time that they are actually allowed to build the markets by law takes 12 years of "red tape."

For all of those who say that the reason people are informals, they don't like to pay taxes, I would simply like to point out that in fact we found that Peruvian informals pay more taxes than Peruvian formals. Only 120,000 Peruvian pay income tax. The majority of government income does not come from income tax. It comes from such things as the gasoline tax which is 40-45 percent of its income. The gasoline, as you know, is mainly employed by the public transport system and that is mainly informal. Another part of Peruvian government income as a source is inflation. In other words, as government produces excess currency and generates the currency that in terms produces inflation, the people who pay for it are those who have to maintain large cash balances. The people who maintain large cash balances in Peru are the informals. We have even found that there are very quaint taxes in Peru like a tax that the street vendors pay in the cities of Peru to municipal police for using the sidewalks, or the plazas, or the roads, and we have found that Peruvian municipalities collect from this tax in Lima alone twice as much

as from legal formal property taxes throughout the country. If you add to that the fact informals have to pay 15 percent of net income, or 50 percent of gross income, to authorities to bribe their way and their appearance on the market, it ends up that the Peruvian informal sector gives more to the state than in fact the formal sector does. So, there's a lot of room for structural adjustment in the informal sector.

Now, structural adjustment doesn't only mean getting rid of laws like the previous list would incline one to do, it also means putting in good law. It means, for example, putting in the right kind of property law. In Peru, we have found out that legal property rights are immensely important for development. One specific case where all this started was in the area of Rima (just outside Lima). We saw two young towns--(Pueblos Jovenes). One of the towns was rather developed with three-story homes with curtains. You could see Toyotas and the Volkswagens downstairs with television antennas on the roofs. There were neatly trimmed lawns outside the houses as opposed to the other town which was a real dump. It was made of cardboard and corrugated iron. We told ourselves that obviously here you have people from two different cultures. The people in the first town are clearly more developed working people and those in the other town are not. We were told afterwards, in fact that the people in both of these places originated in the same Andean village. We studied both of these communities and were able to confirm that both came from the same area.

The difference between them, we were able to confirm, was that the leaders of the first town had dedicated most of their time to obtaining property titles. In the second town people had devoted most of their time to organizing themselves internally. The result was that the people of the first town succeeded in obtaining property titles. To achieve these, they even named their place after the wife of the President of Republic to gain

political favor. The value of their homes after 10 years increased 41 times more than value of homes in the second town. The study has been extended through 38 young towns to make sure that the conclusions were correct, and the finding was that the difference between having a property title and not having one was a difference of 9 to 1 in the value of homes. We noticed, that with property titles you get an access to credit, even if informal credit on better conditions, you get some stability regarding the future, you lose your fear of detection and expropriation and therefore you invest and work, you convert human capital into real material capital. We found that without contracts it was very hard to develop an informal business. There was no way of making long-term arrangements, of achieving economies of scale. Moreover, we also found out that if it takes 289 days to register a business, it also is very difficult to operate on an informal basis. It means an incredible amount of hardship to get businesses together when you have none of the facility aspects of the law.

I always give an example here which I think will be familiar to all of you, because it actually refers to something we've seen continuously in the young towns of Peru which is when people wish to associate together to form a business. **After** all entrepreneurship is all about pooling resources together and combining them in the best way possible. These don't have to be natural resources as the Japanese have proven, as many Asian countries have proven and Western countries who don't have natural resources. They can just be human capital. So, if we are in an situation where there are two Peruvians in a young town, one is Michael, who happens to be Peruvian for this occasion, and myself; I'm a button manufacturer and I'm the best button manufacturer in Lima. It's logical that I should want to be associated with Michael, because, it is known, he is probably one of the best button sellers in town. Now, logically, we should want to get together. The trouble, of course, is that Michael's wife is going to tell him "Now, you've got a problem in associating

with de Soto. After one year, he's going to know who your clients are and then he won't need you any longer. It's a big mistake to associate with him." On the other hand, my wife would probably say something similar: "Watch out, he might learn more about the business." Now, if we were both legal, of course, if it didn't take 289 days to register, we could form a partnership of one sort or another, he could take 30 or 40 percent of the shares in terms of compensating his ability and I could take the remaining--60 or 70 percent. Whatever would happen in the future, we know that in fact he will always get 30 or 40 percent no matter if I become intimate with the customers and no matter if he actually gets to know the business of manufacturing better than I do. Michael will have to associate with someone he trusts and therefore he will associate probably with a family member, somebody either of his wife's family or his family, whom he can control through family or tribal mechanisms, and I will do the same. Then some development expert from the United States will come and visit us, "Look", they will report "Peruvians like to work in small family units."

The law is very important and the law is precisely what keeps microenterprises micro and the fact that people involved in politics and policy adjustments do not study the informal sector very much leads, of course, to this lack of facility law.

Though they are the majority of the country, the informal sector is very unpopular in Peru and in most of Latin America. They're not only called disloyal competition, they are regarded as dirty. They produce a lot of negative externalities. Operating private businesses outside the law makes absolutely no sense. I would like simply to point out the following:

- o the study of the informal sector leads us to confirm that it can be an important source of growth;

- o that it should be an important part of structural adjustment, that structural adjustment is not only policy reforms but that it should try and benefit the informal sector as well.

Structural adjustment will probably only work in democratic developing countries with a large informal sector when you actually get the support of the informal sector and get those in it to identify their interests with structural adjustment. I would even go as far to say that the reason structural adjustment programs of international organizations have not been successful in countries like Peru is precisely because structural adjustment is not popular with the large number of people in the informal sector. This need not be so. As a matter of fact, within the structural adjustment program, there was a proposal to deregulate the 289 days needed to make a firm legal, and at the same time to convert assets into collateral. I'm sure that this action would have the majority of the votes of Peruvians and that politicians would find it easy to carry out structural adjustments in this way; but the fact that structural adjustment does not address the informal sector and generally treats it as the informal sector--the sector that deals with charity which the President's wife takes care of. This means, of course, that these inputs are not politically viable. I will give you one example of something that recently occurred to us in Peru.

We have been trying to promote a change of structure as a matter of the law relating to credit for small enterprises. We developed this project over the last 30 months. I would like to say that we published it on 21 January 1988 in the Peruvian official gazette and by 7 April it had been picked up by representatives of 98 percent of Peru's political parties and introduced into parliament. Moreover, on 10 April, President Garcia converted it into law through a decree because he found it rather popular. The reason he has found it popular, of course, is because we canvassed the informals to support this law.

The informal sector is a class and can be identified as such. We hold hearings, we know their leaders--whether they happen to be of the transport sector, or the housing sector, or the industrial sector, or the street vendors--and we get signatures from them and present these signatures together with proposals. In the case of credit, we obtained 580,000 representative signatures and therefore the government paid attention, because it realized that the informal sector were not only marginal businessmen they were also the majority of voters inside the country. This proposal that we put through, was also based not on a lot of studies of what structural adjustment means from the ivory towers of an ivy league university but were actually the results of observing both foreign Western institutions and our own institutions and how they work.

As you will remember that we saw the informals have property or have possession of property that in Lima alone has a value of \$9 billion. In Peru, in total, it has a value of \$18 billion and if all those \$18 billion exist, why can they not be used as collateral for financial organizations. The reply is, of course, that they are informal, that they are illegal, so the questions is "how can we collateralize them?"

Our first inclination was to title them as quickly as possible because, as we will recall as well, we had found out that once there is title to land, the value of land itself and home goes up 9 times in 10 years as opposed to when you don't have title. So we thought titling was the solution. Now, we found out that, in average, the Peruvian system of titling for people of the informal sector takes 20 years. It is 20 years between the time that you obtain a squat on land and that you actually obtain title. So, we said, "Well, probably we will find something better in Western countries. They must have a better way of doing this" and we travelled around the United States and found out that the only massive titling venture that was identifiable was the

one in Alaska. Because of the pipeline, there were thousands of hundreds of claims from Eskimos wanting their land titled, and we also found out that the solution they gave to that land was to form into corporations because the titling itself was a 16-year process in Alaska. We decided therefore we have very little to learn from the United States. We studied homesteading and found out that it was a more gradual process and also left room for a lot of shooting which we, of course, need less and less in Peru.

Then in California we came across a very interesting institution which nobody had suggested to us. We visited an American company called the First American Titling Insurance Company and found out that they hand out insurance for titles, so you do not need to research your own title. When you buy a home and you obtain title, you get some insurance and you know that any risks that you run are actually borne by the company. Well, in Peru, the problem is, of course, not having titles and so we have a conceptual challenge: "How about possession insurance." The reply was "Well, why not" and that's what we've been working on for the last 30 months and that is what today is law in Peru, and it is a system that we hope to put into effect. It consists of three essential elements:

First it sets up a possession register for informals, secondly possession mortgage for informals, and thirdly credit insurance for informals.

The first thing you need to know if you are going to be able to use the possession of informals, is that it really belongs to him or her and that requires a registry, a registry that says who owns what. The problem of the normal registry in Peru, of course, is that all the requirements to obtain the title, as I've said before, take 20 years.

The first thing that an informal does to assert his property right over the land is build on it. So, we ask ourselves why don't we reverse the process. Instead of finding out who the land belongs to, let's find out who the building belongs to and that's much easier to prove. Because there's no effective police force to provide protection, the Peruvians in the informal sector always first build a wall around the property. As the building themselves touch wall to wall, we told ourselves that the proof of the title is in a photograph showing up to where the neighbors have allowed each neighbor to go and we will assume that whoever has built on the land owns the land. Let's give most of the people the credit required. So, in fact, today, the new registry that will be held by insurance companies and municipalities--jointly or separately--will receive as proofs, first of all, the registers of the informal sector, because there's is no such thing as a land invasion in Peru without a previously drawn map of the area to be invaded, as we found out from the informals themselves from their own (informal) register. From now on that can be legal tender in Peru.

Secondly, if you have to be one of the few people that have not massively invaded land with previous organization, which is rare indeed, you can use the photographs we talked about and the building will certify that you in fact own the property as well. If you happen to be semi-formal and have the receipts of electricity, water, and sewage payments, or you have in fact already paid a tax or you have obtained a loan from a micro-credit organization that also is good evidence to make sure that you are included in the register. As a result, we expect that in Peru, 4 years from now, the informals' homes in Peru will have risen by \$3 billion, simply through registration.

Now, what do we do for credit. Well, the idea is to make the possession that is registered, for all practical effects a property that can

be handed over to an insurance company or a credit institution in the form of a mortgage. The way we actually stimulated the informals to obtain mortgages is that we said that in countries like the United States, 80 percent of small businesses started up through home mortgages and how was it possible in Peru that this is so ignored. What informals did in Peru was to let government know that they, too, had the right to a mortgage? We have therefore established by law a system through which the established possession is actually registered. This can be handed over to the majority of the Peruvians which today have property of sorts. This allows them to obtain credit if they are adequately registered.

There cannot be a country that has 50 or 60 percent of its population that is informal, without some kind of law or common law actually guiding or ruling their transactions. So, we have adjusted these laws--our laws--to fit the case of the informal sector. One of the main problem is to make sure that nobody speculates with their land. If there are foreclosures on the mortgages, if somebody who obtained a credit using the mortgage cannot pay that credit, the property is auctioned off, but only to people who also live in these "young towns", only to people who one way or another are people who do not already have a home. Moreover, the mortgage can be deposited as a trustee in the hands of the "informal" authorities who are the elected authorities of the "young town" and they can decide whether they're going to support the cause of the person who has defaulted on his payment or whether they are going to act so as not to lose credit for the whole neighborhood. We have placed these decisions in the hands of the informal authorities themselves.

In terms of the credit industry, which is the third pillar of the system, we have also simplified things. One of the reasons banks do not serve the informals is because the informals don't have collateral. With the

registration system and the mortgage, they now have collateral, but it's still too complicated for banks. As you know better than I do, it is much easier to develop a hundred loans of \$500,000 than 500,000 loans of \$100.00. Some banks just don't want to be bothered with property that, on average, as in case of the informal property in Peru, has a value of \$9,600.00 per unit. However, we found out that insurance companies in Peru were very interested in looking at that kind of property. They insure bicycles and motorcycles and they would be willing to give out credit insurance. In other words, they would be willing to accept the mortgage and on the basis of the mortgage extend a letter of credit of sorts to the informal who would then go to the bank and solicit credit on the basis that his guarantor was a triple AAA insurance company.

So far, the government, the private sector, the informals and all the political parties of Peru, from the extreme left to the extreme right, have accepted the project. We expect that will allow us to raise, without using foreign resources from international organizations, credit to the informal sector from 1/2 percent of the total credit market to 5 percent of the total credit market in the next 4 years. In other words, we expect that about \$200 million of Peruvian savings will be able to go to the informal sector. Moreover, we expect that only the installation of the system will increase GNP per capita by 1.2 percent per annum.

Now, let's look at what that particular measure, which is one of the many we have suggested on how to relate structural adjustment to the informals, will do. By addressing the needs of the informals, we have been able to obtain 98 percent political support for structural adjustment. It has given the dispossessed majority a stake in the private sector economy. It has ensured that every person, each of whom is a potential member of a terrorist movement in Peru, becomes a part of the system. We have begun to deregulate the banking system by simply creating a parallel to work with which even

people with titles will want to use because credit insurance is an additional security. We have been able to give the formal private sector an interest in the informal sector which previously they thought was only disloyal competition. We are reducing the scope for corruption and we are reducing the dependency on foreign sources of support. We are decentralizing by using more informal mechanisms and the elected political authorities of the informal sector and we are recognizing the registers as sources of formal law. We are also, of course, by not limiting these loans to small enterprises allowing the quick graduation without anybody having to make a political decision and we are bringing in something that Anglo-Saxons thought was their privilege--the common law into the statutory legal system.

We did this by making the project popular with the informal sector who are the majority of the voters that politicians listen to in developing countries. In other words, structural adjustment needs the informal sector as much as informal sector needs to be considered by structural adjustment. Essentially the message behind this is the following:

The informal sector is not a marginal sector. It is the majority of the people in many developing countries. It is important if you want to transform your countries democratically to use their will. People from the microenterprise sector must actually be heard. The informal sector, as Marxists would like to hear, is in fact a social class, it is a group of people who have entrepreneurial abilities, but who are also dispossessed and poor and who are also being fought over by people who believe that they are nothing more than a proletariat. If you want structural adjustment to make sure that certain values are kept, or certain values are introduced in developing countries, like markets, like private entrepreneurship, like

democracy, it is important that the informal sector stop being the poor cousin of financial organizations but that they actually become the focus and not the enemy of structural adjustment.