PN-ABF-847
67735

Sequoia Institute is pleased to announce the convening of the second in a series of seminars addressing critical issues of Third World development on Thursday, October 22, 1987, at the Vista International Hotel in Washington, D. C. (1400 M Street, N. W.). The seminar addresses "The Underground Economy and Growth in LDCs," in accordance with the following agenda.

7:45	Coffee
8:15	Introduction of Agenda and Contributors
8:30-10:15	Presentation and discussion of "Constraints on People: The Origins of Underground Economies and Limits to their Growth." Introduced by the paper's author, Hernando de Soto, and commentator, James L. Payne.
10:15-12:00	"Underground Economies: Generic or Sui Generis?", asks whether underground economies are unique to Latin American countries or are simply the most highly publicized instances of a general phenomenon. Invited to answer this question is Janet Landa and commentator, Robert H. Bates.
Lunch	~~Speaker~~ optional
1:30-4:00	In what ways, and by what means, might the assistance of individual enterprise in developing countries overcome the "formal," "informal" and "underground" divisions within their economies This vexing question is among those addressed in a paper by Tyler Biggs, Merilee S. Grindle and Donald R. Snodgrass, with the assistance of Susan Coleman, entitled, "The Informal Sector: Policy Reform and Structural Transformation". Lead-commentator, John P. Powelson initiates the discussion of this paper.
4:00-4:30	Wrap-up of the day's discussion.
4:30-6:00	Closing Reception

(3pm) break

INCLUDING THE EXCLUDED: Extending the Benefits of Development, is the theme of a series of seminars introduced by Sequoia Institute in 1987. Expected to conclude in 1991, the series seeks to shed new light on critical issues of "third world" development -- light that will enable development assistance to accelerate the inclusion of all people in the process of individual and societal development.

Fora

In order to facilitate an intensive exchange of views, each of the day-long seminars is restricted to no more than 50 participants, including authors and lead-commentators on papers prepared for the series. Dialogue is additionally facilitated by delivery to invited participants of the three papers prepared for a seminar at least one week prior to its convening.

Because attendees will have already read the papers, the time allotted for authors' introductory presentations of their work is limited to 15 minutes. A like amount of time is accorded to lead-commentators for initiating the general discussion among all attendees. The hour- to two-hour-long discussion of each session correspondent with a paper may largely consist of questions and answers, and an author may, in fact, occupy most of a session's time in the course of addressing issues raised by other participants. The final 10 minutes of each session are allotted to author(s) for the presentation of concluding remarks.

Both the structure of each seminar's proceedings and the characteristics of invited participants reflect a preeminent objective of the series: to serve as a catalyst for a new generation of thinkers and ideas on development and its assistance.

This endeavor is epitomized by the series' "select scholar" program.

Select Scholars

Approximately ten of each seminar's invited participants are selected from nominations of outstanding scholars who are relatively "new" to LDC/international development issues, by virtue either of their youth or of their concentration of previous scholarship on other subject matter.

Nominations of "select scholars" for participation in the series are welcomed from social scientists throughout the United

States. A nominator's letter of recommendation should indicate for which seminar(s) the nominee's participation would be of greatest mutual value, and be accompanied by a resume reflecting the nominee's qualifications.

Nominations should be mailed to:

Select Scholar
Sequoia Institute
3353 Bradshaw Road, Suite 121
Sacramento, CA 95827-2609

The select scholar program embodies the intention of the series to encourage increased (and fresh) attention to third world development issues both among younger academics who might become specialists in the field and among established scholars who might never become "third world specialists." What all have in common, however, is their demonstration of: (1) original thinking, (2) outstanding scholarship, and (3) keen interest and penetrating thought regarding development issues.

Publications

In order to serve as a catalyst for a new generation of thinkers and thinking about development and its assistance, the dialogue of the seminars must reach the vast audience unable to have participated in their occurrence. To this end, ICS Press is publishing and distributing the entire series' product. Thus a widely advertised volume will result from each of the seminars.

In addition to at least three papers and lead-commentaries prepared for a seminar, the corresponding book includes selections from the transcribed discussion of each paper and commentary, and the authors' conclusions in response to the commentary and discussion of their respective papers.

In order that the ensuing book might accurately reflect their thoughts, each participant is provided a complete transcript of the seminar which she or he attended, and approximately two weeks after receipt of the transcript to revise and/or elaborate upon contributions to the day's proceedings. Within one month of a seminar's occurrence, authors are provided copies of these revisions for enabling them to prepare fully responsive conclusions regarding their respective topics.

Series Titles

The first seven titles in the projected 10-seminar series, by the anticipated date of their occurrence, are:

C

1. Policy Reform and Equity
   (May 20, 1987)

2. The Underground Economy and Growth in LDCs
   (October 22, 1987)

3. Trade and Development: Development Priorities in the Uruguay Round (January 15, 1988)

4. Capital Markets and Development
   (May 1988)

5. Democratic Institutions and Development
   (September 1988)

6. Technological Change and Development
   (March 1989)

7. Culture and Development
   (September 1989)

Seminars are scheduled well in advance in order that few individuals will be precluded from contributing to the series due to prior commitments. Nonetheless, the anticipated dates of seminars four through seven are subject to some modification, contingent upon their acceptability to potential contributors.

In addition, the subject matter of the three seminars that will conclude the series are intentionally unspecified in order to enable responsiveness to emerging interests and intensities of preference of a new generation of development thinking.

Individual Seminars in Series Context

The initial seminars. No two seminars could be better suited for introducing and illustrating this theme than those launching this series. "Policy Reform and Equity" is in many respects the other face of "The Underground Economy and Growth in LDCs." That is, the accomplishment of policy reform and equity decreases the need for and growth of underground economies. The growth of underground economies is often a testament to the large number of people engaged in beneficial economic activities who are effectively excluded from participation in formal economies. Burgeoning undergrounds, bear testimony to the stark inequality among peoples' opportunities to attempt to achieve in accordance with their aspirations.

Underground economies are a product of policies in need of reform. But while their growth can be a tribute to the

individuals who create and sustain them, they are not themselves to be glorified. Far better that changes in institutions and policies were effected whereby the occupants of informal economies could become participants in formal economies that exclude no one.

The first two seminars establish that issues of growth and equity are inseparable. The exercise of a country's full range of talent and energy is inhibited by institutions and policies with criteria that address characteristics other than individuals' skills and efforts. Such exclusions make for inefficiencies, reducing economic growth.

This series and its theme are an extrapolation from the policy dialogue endeavors of its sponsor, the Agency for International Development. Underground economies would not exist but for restrictive government policies and practices, many of which have been targeted by A.I.D.'s policy dialogue for at least the past six years. The Agency has anticipated what has been increasingly recognized by many LDC governments. This seminar series is expected to carry forward and broaden the scope of an ongoing policy dialogue debate.

The third seminar. The concerns addressed in the initial seminars are extended in the third to the international arena. The adoption of increasingly exclusionary (e.g., protectionist) policies by the major industrial countries is likely to reinforce restrictive policies of Third World governments. Barriers to domestic competition are increased, not diminished, by the expansion of exclusionary policies in the arena of international trade and investment.

During the initial meeting of the Uruguay Round of multilateral trade negotiations, the delegates agreed that there will be increases in the contributions and negotiated concessions of developing countries in correspondence with improvements of their economies and trade situations. Therefore, the central questions to be addressed in the third seminar are: what LDC strategies will be most beneficial to them in light of the agreements of the initial meeting of the Uruguay Round; how should the New Trade Round take account of the special needs of the least-developed countries; what concessions by developed nations are of most value to developing nations; what inclusionary international trade policies by the NICs should be promoted; and finally, what inclusionary trade policies would be most conducive to the adoption of corollary policies within countries?

The fourth seminar explores issues related to capital markets in developing countries. In many LDCs, a variety of government regulations and economic policies have discouraged

domestic savings and have restricted local and foreign investment. These policies and regulations effectively exclude from formal markets the investments and commercial transactions that otherwise might have occurred, and thereby inhibit the growth and maturation of indigenous capital market institutions. The consequences have been less saving, less investment, less efficiency, and less growth than is experienced in countries where policies and regulations do not discourage the entry of individuals into formal capital markets.

The correspondence between human capital flight (to undergrounds) and monetary capital flight (to other countries) underlies questions to be addressed by this seminar regarding the impact which changes toward more open capital markets might have on capital flight, income disparities, and investment disequilibria.

Some LDCs are now studying ways to facilitate capital market development by reducing inhibiting regulations, strengthening local institutions and stimulating on-lending and private foreign investment flows. In recognition of these ongoing assessments, the fourth seminar will be concerned with examining policies which LDCs might adopt for facilitating the development of indigenous capital markets.

Seminar five examines the inclusiveness (exclusiveness) of political and economic institutions, and explores both their interrelationship and their consequences for the economic growth and development of countries. The central question of this seminar will be: What democratic institutions promote or are necessary for a viable and peaceful transition from mercantile (exclusionary) to market (inclusionary) economies, thereby enhancing the accelerated growth of both economies and equity?

Inclusionary markets have been impeded by the politicization of economies both in countries which possess democratic political institutions and in those which do not. Conversely, inclusionary markets have been established in countries whose democratic institutions are shallow and limited as well as in those where these institutions are deep-rooted and extensive. Given these juxtapositions, each of the contributors to this seminar is expected to provide one or more answers regarding the institutions of political democracy that are "necessary and/or sufficient" for enabling greater equality of opportunity among individuals to participate in both polities and economies. Among the factors to be considered in assessing this relationship are institutional weaknesses and political extremism.

Technological change is addressed by the sixth seminar. The technological revolution shows no signs of decelerating. It

has expanded the potential for positive interdependence between countries and, in some cases, altered the comparative advantage of labor-intensive modes of production. Indeed, there is a strong case that the bio-genetic technology underpinning the Green Revolution has generated another revolution wherein investments of capital and labor are no longer inversely related. At the very least, one result of the ongoing technological revolution is an almost constantly changing agenda.

Ten years ago, this seminar might have confined itself to addressing the optimal mechanisms for facilitating technology transfer and LDC strategies for coping with technological change. These important issues remain, but today, the determination of which technologies are most appropriate to any given country are themselves increasingly uncertain. Hence, decisions regarding the optimal technologies to be transferred, and the optimal means for their transfer must be conditioned by questions as to the optimal means for determining which technologies should be transferred.

One thing is clear. The technological revolution has increased the capacity of individuals within LDCs to participate in the international market no matter how exclusionary their government's institutions and policies might be. An implication of this phenomenon is that exclusionary policies of any government are subject to expanded circumvention by their citizens. Another implication is that exclusionary institutions and policies of governments are being undermined by changes over which no government has control. Yet another implication is that those governments which understand this revolution least are likely to suffer most.

Some governments attempt to exclude their countries from both the effects and precepts of the revolution in technology. Today, the most publicized of these governments are those enmeshed with Islamic fundamentalism. Such considerations are incorporated by the subject matter of the seventh seminar. It inquires into what can be the most the most intractable sources of exclusionary institutions, policies and practices. These include divisions among people that are either imbedded in differences of race, nationality, lifestyle (including religion) and gender or that are established within these sources (e.g., a caste system based in religion).

Culture, at root, is a product of the ways in which a people think.

It is appropriate that a seminar series which strives to encourage new thought about development should address how we think others do about their own futures.

Academic Advisory Board for...

INCLUDING THE EXCLUDED:
Extending the Benefits of Development...

a seminar series addressing critical issues of foreign development and its assistance; conducted by Sequoia Institute, with the sponsorship of the Agency for International Development.

Nicolas Ardito-Barletta
General Director
International Center for Economic Growth
Panama

Robert H. Bates
Political Economy Center
Duke University
Durham, NC

Elliot Berg
Elliot Berg Associates
Alexandria, VA

Brigitte Berger
Department of Sociology
Wellesley College

Peter L. Berger
Director
Institute for the Study of Economic Culture
Boston University

A. Lawrence Chickering
Executive Editor
Institute for Contemporary Studies
San Francisco, CA

Hernando de Soto
President
Institute for Liberty and Democracy
Lima, Peru

Lee Edwards
President
Center for International Relations
Washington, DC

Jerry Jenkins
Executive Director
Sequoia Institute
Sacramento, CA

Elliott Morss
Center for Asian and Development Studies
Boston University

Douglass C. North
Director
The Center in Political Economy
Washington University
St. Louis, MO

Elinor Ostrom
Co-director
Workshop in Political Theory & Policy Analysis
Indiana University

John P. Powelson
Department of Economics
University of Colorado

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

Hernando de Soto

I. SUMMARY

The Instituto Libertad y Democracia (ILD) has come up with striking new conclusions about the causes of Latin American underdevelopment and how to resolve it through its study of the informal sector.[1] The publication of the book setting forth its thesis, El Otro Sendero (The Other Path), has sparked unprecedented interest throughout Latin America. It has been widely recognized as representing a new trend in Latin America -- a non-Marxist, non-"dependencista" and anti-oligarchic alternative.

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

[1] The informal sector is composed of those people who, although pursuing legal ends, such as building a house or operating a business, have not met all of the legal requirements to do so.

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

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

Informality is a symptom of institutional disfunction because it indicates that much of the law has lost its legitimacy. Obviously, then, the key question is why informality exists. Our research reveals that, because of the labyrinth of rules and regulations, it is virtually impossible for poor people to comply with all of the requirements to live and work legally. And, even for those who are able to do so, the costs of remaining legal are overwhelming. The result, as the ILD demonstrates with facts and figures, is that the

productivity of the whole country is lowered dramatically.

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

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

Mercantilism centralizes economic and political decision making in a small elite. In Latin America today, whether their ideology is of the right or left, civilian or military, the elites rule in the same way -- through closed, special interest legislating. For example, in Peru an average of 99% of all rules and regulations are passed without public consultation -- or often, even knowledge. And

this figure does not differ significantly no matter who is in power. Moreover, there is no public accountability. Thus, though there may be elections, most of the basic institutions required for a participatory democracy -- government by the people -- simply do not exist.

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

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

The foregoing means that blind support for many of the prevailing systems in Latin America is a mistake for they are not the open democracies and economies of the west but, rather, the mercantilist predecessors of both the western and communist systems. Support for mercantilism seems doomed to failure because today it is being massively disobeyed by the informals and rightfully challenged

by the communists. It is, therefore, crucial to end this tragic confusion and to clearly distinguish between mercantilism and modern systems. The answer, the ILD maintains, lies in adopting those legal institutions which make democracy and markets work for everyone and whose roots are found among Latin informals and western nations.

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

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

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

In less than four years the ILD has gone from pursuit of a troubling question -- why does informality exist -- to a major breakthrough in development thought. It has identified the key

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

II. RESULTS OF THE ILD'S ACTIVITIES

A. First Finding: Entrepreneurial Energy of Popular Origin

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

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

Another economic sector in which good evidence was found is commerce. Through field work and two censi conducted in 1985 and

1986 it was established, in the first place, that there are 91,455 street vendors in the capital representing 42.2% of labor involved in commerce, distributing approximately 60% of the food in the city and earning an income almost 40% greater than the minimum income allotted by the government.

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

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

Finally, in spite of the fact that informal industry is the most difficult sector to quantify because it operates "underground," the

methodology used has revealed meaningful information. Among it, that informality covers areas as broad as mining equipment, bicycles, preserved meat and fruits and that it accounts for at least 60% of the production of garments and furniture and some 35% of textile production. The ILD's estimates indicate that informal industries compose 52% of industrial production establishments, employ 34.2% of industrial workers and generate 18% of the value added in the whole sector.

B. Second Finding: An Inoperative Legal System

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

1. The Obstacles

Obstacles occur at two levels: in access to formal economic activities and in remaining in them. The ILD demonstrated that, in

order to operate legally, people have to meet a series of costs imposed by the state under different regulations. For example, in the case of housing, the major portion of the population does not have the resources to buy a piece of developed land in a residential zone. Thus, their only legal alternative is to request government adjudication of an undeveloped plot of desert land -- which is one of the most abundant resources of the country. However, the ILD found, by following the trail of actual documents, that the procedures for adjudicating undeveloped state land actually take a minimum of 56 months of effort and the completion of 207 administrative steps, involving 48 public offices. The cost per family, not counting the purchase value of the land, is $2,156, the equivalent of 4 years and 8 months income for a person who earns the minimum wage. To this must be added 27 months of red tape to obtain the license to develop the land and build on it. All of the steps required to legally obtain a piece of undeveloped land on which to build take, on average, 7 years.

As a result of such obstacles, invading land has become the only recourse of the poor for gaining access to housing. The discrepancy between the human need for housing and the formal system of access to it is clearly demonstrated by the following. During 1985 in Lima, according to police statistics, there have been 282 invasions of public and private land giving rise to a similar number of housing settlements. Meanwhile, in this same period of time, there were only 3 legal adjudications of land. These invasions are organized and generally involve from 10 to 40,000 people. Most invaders of public land will eventually be recognized by the state, but to get legal

title to their plots the settlers will have to comply with red tape that takes an average of 20 years to satisfy. Until they obtain title, their status is informal.

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

With regard to commerce, the ILD has calculated that street vendors, due to their informality, have to wait an average of 12 years from the moment they decide to construct their markets or commercial centers until they can begin to do so. Of this time, 9 years and 8 months are required for complying with bureaucratic steps and the rest of the time is taken in organizing themselves informally as entrepreneurs. It takes this long because they do not have access to adequate legal forms of business organization.

The case of transport is even more dramatic. The state simply does not permit legal access. It only sporadically allows those who have already invaded transport routes to receive formal recognition. If legal access were permitted, our best estimate is that compliance with red tape would take 3 years.

Finally, in industry, the ILD conducted a complete simulation of the legal process that must be followed to legally register and commence production. This was done by installing a small garment factory, with two sewing machines, in an industrial site on the

outskirts of Lima. Four university students and one administrative lawyer completed all of the legal requirements, going from office to office soliciting the different, required permits and licenses. They kept careful records of the time spent and, afterwards, diagrammed the results on a "pert" chart. Working 6 hours a day, it took 289 days to complete the red tape requirements. Ten times they were asked for bribes and were forced to pay them on two occasions in order to proceed. In terms of foregone income and expenses incurred, the 289 days are equivalent to a cost of $1,231; 32 times the minimum wage established by the state.

Legal obstacles not only limit access to sectoral activities, but also to factor markets. One dramatic example is access to capital. 85% of all credit in the financial system is offered by institutions partially or totally controlled by the state. Yet the informal sector receives only 0.2% of credit in the official system and must resort to costly and difficult informal sources. Meanwhile, many in the formal sector legally receive subsidized credit which, of course, comes at the expense of savings. Thus, no real credit market exists, but rather a politically controlled segmentation of available credit based on influence. As a result, the possibilities for economic expansion and social progress by the most needy classes are stunted.

A similar situation exists with regard to the external debt. The oppressive weight of the debt is the direct result of an institutional structure that permitted government and state-owned companies to contract large loans and projects from foreign banks and contractors. Now that the debt has become too heavy to be supported

by these entities, the rest of Peru has to pay the price, be it through the government's limitation on repayment -- thereby avoiding new capital investments in the country -- or through beginning to pay the debt -- thereby draining away funds that could otherwise be invested in activities to promote growth.

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

2. The Lack of Facilitative Law

The expense of entering the formal sector and remaining there forces most Peruvians to operate outside the law. This means that informals cannot take advantage of the facilitative aspects of the law, principally property rights, security of contracts, and torts. As the ILD has discovered, this has enormous implications for development. Indeed, how much investment would have taken place in the western world without well-defined and secure property rights and court systems to protect them? How many inventions would there have been without patents or royalties? How many long term investment projects would have been begun without secure contracts? How many

risks would have been taken if there were no limited liability or insurance policies? Or how much capital could have been pooled without limited liability companies and shareholder systems? How many times could one have failed and then started again if debts could not be converted into shares? And how many companies could have prospered and grown over time if there were no perpetual succession? Could industrialization have taken place without economies of scale? Yet, the informals lack all of these facilities because they are on the margin of the law. Given the importance of these facilitative aspects of the law, it is worthwhile considering them separately.

a. Property Rights

Property rights serve a fundamental economic function; the assignment of resources. Without well-defined property rights, all activity and interchange is difficult. When neither exclusivity or the right to transfer resources exists, the means for determining relative values and for maximizing economic benefits are lacking. On the other hand, the more secure are property rights, the less costly will be transactions, and the greater will be the interest in discovering and taking advantage of existing economic opportunities.

Thus, the function of property rights is to encourage those who hold them to add value to them by innovating, investing, or combining them productively. All of our empirical research regarding property demonstrates incontrovertibly that the lack of secure property rights enormously reduces the productivity of the majority of Peruvians. Not having legal recognition of their possessions causes people in informal settlements to limit their investment in them. Through a

sample of 38 settlements, it was determined that, on average; investment increased 9 times once people had title to their land.

b. Contracts

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

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

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

c. Torts

A final facilitative function of the law is to repair or prevent the effects of a person's actions, not foreseen in specific

contracts, on others. For this formal society establishes a system of torts, or extracontractual responsibility, which requires compensation for those injured by negative externalities.

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

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

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

d. **Other Advantages of the Law**

Obviously, popular entrepreneurship functions poorly without adequate institutions. To the limitations listed above, many more can be added. Lacking formal status, informals do not have access to credit nor can they advertise effectively. For fear of detection, it

is virtually impossible to achieve economies of scale. For lack of coercive power, they cannot develop the public goods they need nor stand up to the power of monopolies. And the lack of courts and tribunals that function efficiently means that more conflicts end up being resolved violently.

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

C. The Cause: Mercantilism

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

From 1947 to 1985 the executive branch emitted annually 99% of the Peruvian rules and regulations while Congress approved only 1%.

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

Such evidence makes clear the way in which the Peruvian state governs. The only citizen participation is a system for electing a government every 5 years. There is nothing to democratize decision making. Obviously, this is equivalent to making out a blank check to the President. As time passes, this has negative repercussions on the government's own legitimacy as it has no structured way to receive feedback from citizens on its actions. This helps to explain why democracy in the country has lost so much respect and why governments are so weak at the end of their mandate. There is a close relationship between the lack of an institutional structure that allows a market economy to operate and lack of one that allows a democratic system to function in the country.

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

favorable rules and regulations than from directly supervising production in their plants.

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

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

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

D. The Road to Reform

The informals are not only a symptom of the problem facing Peru, which is its mercantlist structure of governance, but also a potential route to reform. Representing some 60% of the population,

they are a potent source of support for reforms that would give them a stake in the society. Thus, not only have we configured the problem but we have identified the direction in which a solution lies.

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

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

To date, all four of the laws proposed by the ILD have been picked up by the authorities in one form or another. On titling of homes in Lima, we proposed specific reforms in the ABIPs. We followed the ABIPs with public meetings at which our proposed legislation was discussed. Following the public meetings, we asked people to register their complaints against the existing system with

us. We received 300,000 complaints in one month. The impact was not lost on the politicians. President Garcia immediately launched his own titling law which was passed by Parliament, with a few modifications suggested by the ILD. The Apristas (at the national level) and Communists (at the municipal level, who are traditionally against private property) then began to fight among themselves for the privilege of being the ones to offer titles to informally acquired land.

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

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

III. IMPLICATIONS OF THE ILD'S ACTIVITIES

Although much more research and analysis is necessary, what the ILD has done to date has begun to undermine the major anti-democratic

and anti-entrepreneurial theories current in Latin America today. It has done so by demonstrating conclusively that some of their fundamental assumptions about the nature of the social and economic order are simply incorrect. This is certain to have practical consequences since the policies current in Latin America today are backed by one or more of these development theories.

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

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

A. The Cultural Hypothesis

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

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

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

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

B. Marxism-Leninism

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

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

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

Latin American Marxist parties have tried to get around this inconvenient fact by subtly redefining "proletarian" so as to embrace all who are left out, exploited or oppressed by capitalism, whether or not it occurs by way of the wage system. To do otherwise --

to admit that the proletarian condition is nowhere near universal -- would undermine the fundamental base of their ideology.

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

Unlike the proposals of the Marxists, those of the ILD are based on the empirically identified class interests of the people who are to be aided and offer practical remedies that depend largely on their mobilization on their own behalf. Even if Marxism has had some success in coopting urban informals by fighting for their rights, studies have shown repeatedly that these people support it for purely tactical reasons and rarely, if ever, share its larger vision. A recent political incident in the Lima barrio of San Martin de Porres confirms that this approach exists, even among fairly high-ranking Marxist pary cadres. The district Mayor, an official of the most "hard-line" component of the United Left coalition, was attracted by the value of the ILD's proposals for the needs of his constituency. He asked us to design the program specifically for his district and publicized the ensuing joint venture. His daring initiative

subjected him to intense political pressures from the party leadership and he was ultimately forced to undergo a humiliating public "self-criticism". However, following this incident, three of the council members came to work with us, attracted by the practical solutions proposed. There are numerous other examples of support for our positions by those of supposedly Marxist inclinations. For example, the Parliamentarians of United Left Part have been among the main supporters of various ILD legislative initiatives. Much of the press on the left has also been supportive, designating El Otro Sendero "a support to the construction of socialism in Peru". What all of these examples indicate is that practical solutions to reform the system have much more appeal to most than empty ideological abstractions.

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

C. Dependency Theory

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

Then, starting in the early to mid-1960s, leftists found a way to combine CEPAL's structuralism with Lenin's ideas about the inherently imperialist nature of capital on a world scale. Lenin argued that certain internal "contradictions" of the capitalist system required the systematic colonization and exploitation of the world "periphery" by the developed countries of the "center", since otherwise the system would collapse. To this the leftist added two innovations. Whereas Lenin had pictured the "center" as rent by "inter-imperialist" rivalries and doomed to constant warfare, the new paradigm portrayed the "center" as a cohesive structure of domination

organized and led by the United States. And whereas Lenin had relatively little to say about the detailed forms that this "exploitation" assumed, the new paradigm professed to find these forms in the structural features that CEPAL had identified. This marriage of Lenisist theory and "Cepalismo" became known as "dependency theory".

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

However, the dependency idea has acquired an ideological presence independent of its failures as theory. There are three reasons for its continuing appeal. The first is that it is an eminently nationalistic ideology in third world terms. In fact, it is the characteristic form assumed by Latin American radical nationalism in our time, which points to an important historical lesson: nationalism, not Marxism, has consistently proven to be the most attractive political ideology of modern times. Second, dependency theory enables third world political leaders, along with the oligopolistic, privileged, corporate elites who associate closely with them, to shift the blame for their policy failures onto the

shoulders of an international system for which these leaders and oligopolists could not be expected to be responsible. Finally, the apparently radical features of dependency theory give the leaders who cater to exacerbated nationalism a way of coopting local Marxists and/or of appealing directly to the Marxists' ideological consitutency.

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

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

structures. The ILD has identified these local sources and recommended purely domestic policies to eliminate them.

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

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

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

D. Liberation Theology

The Theory: twenty-odd years ago there arose a Latin American variant of European "political theology." It first took institutional form as "Cristianos por el Socialismo" in Chile during the Allende period, although its best-known current embodiment is the Sandinista "Iglesia Popular" in Nicaragua. The prominence of

Liberation Theology as both a political ideology and as a movement is particularly noteworthy in Peru and Brazil, where two of its major proponents (Gustavo Gutierrez and Leonardo Boff, respectively) reside. It has gained strength within a surprisingly high strata of the Church hierarchy in addition to the priesthood and laity. It also enjoys a considerable following in the United States, especially within those priestly and monastic orders that operate programs in Latin America.

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

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

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

assuring that their new political order will be any more just than the old one.

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

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

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

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

E. The Foreign Policy and Assistance Programs of the Developed Countries

The Problem: developed countries have faced two problems in achieving concordance between their basic values and their foreign policy and assistance programs. The first is that they have often confused mercantilists with modern market systems and democratic elections with full-fledged participatory democracy. Yet, as the ILD's research has shown, the mercantilists are not capitalists of the type found in the western world and democratic elections in no way guarantee citizen input and oversight in the rule-making process nor any accountability what so ever. Thus, many occidental nations

have often ended up supporting regimes whose practices bear little resemblance to the values for which they stand.

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

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

In addition, by supporting, or appearing to support, special interests, western developed nations have been playing into Marxist hands. The Marxists have identified themselves with the interests of

the "proletarians" whom they have redefined to include the poor and oppressed. Thus they are seen as standing for change in the present structure while the West is left as the guardian of the status quo.

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

F. The External Debt

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

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

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

Even more importantly, conditional loan programs ignore the vital role of institutional reform at the microeconomic level. As our research has demonstrated, countries such as Peru lack many of the institutional prerequisites for facilitating economic growth. A legal system that does not guarantee the fundamental rights of property, contract, legal process and commercial organization to the majority of its citizens cannot maximize incentives to innovate, invest and produce. At the same time, the legal system imposes

excessive charges on the private sector through red tape and regulation, discourages private initiative and increases the costs of goods produced. In this setting, the traditional prescriptions of structural reform are destined to fail because they do not get at the heart of the problem which is a mercantilist structure that limits competition, functions on favoritism rather than efficiency, and represses entrepreneurship.

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

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

Therefore, methods that now seem to favor foreign interests, could be seen as benefitting the majority of Peruvians. What is even

more fundamental, the implications of the ILD's studies are starting to demonstrate to the Peruvian public the virtues of the markets and the democratic practices the informals have unconsciously developed.

G. Increasing Economic Growth[2]

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

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

[2] This section is excerpted and adapted from "Internal Structural Reforms in Peru: a Promising Road out of the Debt Crisis" by Robert Litan, Luis Morales-Bayro, and Jorge Fernandez-Baca, published in Journal of Economic Growth, Vol. 1, No. 2 (Second Quarter, 1986), pp. 28-35.

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

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

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

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

would allow informal entrepreneurs to expand to more sophisticated technology, as well as the credit with which to purchase it.

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

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

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

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

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

VI. CONCLUSION

The evidence gathered so far suggests that stable development will be possible only when mercantilist institutions are changed for those of a modern market economy and participatory democracy. While many countries, particularly in Western Europe, have made the transition from mercantilism to modern states, they did so through a process of spontaneous evolution that remains to be charted. Therefore, our plan is to research and map out the steps required for said transition in the context of Peruvian and other Latin American realities and continue implementing our proposals as the best test of their viability. Concretely, in Peru, we plan to focus our efforts on four principal areas:

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

Oct. 12, 1987

Underground Economies: Generic or Sui Generis*

By

Janet T. Landa**

Introduction

The central conclusion of the preceding paper by Hernando de Soto is that Latin American legal institutions discourage entrepreneurship. This is because of the costliness of complicance with the labrinyth of rules and regulations associated with existing Latin American "mercantilist" policies. As a consequence, many low-income individuals in Peru, for example, are forced to exit from the formal sector and enter the underground or informal sector. Within the informal sector, the "informals" have created for themselves "extra-legal norms" as a substitute for the law:

> We have found no dictatorships, or mafia type organizations, no kolkhoz or ayllus but, rather individual or family ownership, and rules that attempt to create fair competititon through extralegal norms for property, contract rights and torts (p.14).

Consequently, these extra-legal institutions created by large segments of the indigeneous population are:

> ...eminently democratic and the economic system they have devised is a non-discriminatory market economy. Therefore the informals are the largest, as yet unrecognized, totally nationalistic constitutency on the continent for participatory democracy and a market-driven economy (p.2).

However, the lack of efficient laws means that for the formals remaining in the formal sector, the costs of compliance with legal rules remain high. As for the informals, operating outside the law, they "have little choice but to associate themselves almost tribally, with close family members and limit themselves to artisanal production and small firms (pp. 9-10) . Thus the overall productivity of the Latin American economies is lowered. The empirical findings of the vitality of the informal sector, led de Soto to challenge existing theories or hypotheses , which in various degrees serve as

the bases of current Latin American developmental policies —cultural hypotheses, Marxism-Lenism, dependency theory, and liberation theory—as being inadeequate in coming to grips with the root cause of Latin American underdevelopment. The key, according de Soto, "lies in adopting those legal institutions which make democracy and markets work for everyone and whose roots are found among Latin informals and western nations (p3)." This conclusion, based on empirical evidence gathered from a study of the informal sector in Peru, led de Soto to state that:

> The Instituto Libertad y Democracia (ILD) has come up with striking new conclusions about the causes of Latin American underdevelopment and how to resolve it through its study of the informal sector (p. 1) .

Two preliminary remarks are in order. First, de Soto's view that (efficent) laws are essential in facilitating exchange and economic development is not new. This view that "laws and institutions" are important in promoting exchange and development is at the core of a body of literature, more narrowly conceived as the Property rights-Public Choice theory/Transaction Cost Economics, or more broadly conceived as the New Institutional Economics. Second, the conclusion that the root cause of underdevelopment can be understood from a study of the informal sector is also not new. I arrive at the same conclusion from an empirical and theoretical study of the economy of the ethnically homogeneous Chinese middleman group in Southeast Asia: in order to encourage indigenous entrepreneurship, the government either has to provide a well-functioning legal infrastructure for the protection of contracts, or encourage the indigenous population to rely on local community action so as to create for themselves the kinds of cultural norms of behavior that the Chinese have created for themselves to facilititate them in their middlemen role(Landa, 1978; 1 983). Nonetheless, the most important contribution of de Soto's paper is its recognition of the importance of efficient laws for encouraging entreprenership and economic development in Latin American countries

The aim of this paper is : a) to provide evidence that the existence of an informal sector where informals themselves have created extra-legal norms is not unique to Latin American countries but is part of a more general phenomenon found in LDCs where the legal framework is not well-developed. The most conspicious examples of the phenomenon are found in

the trading sectors dominated by foreign ethnically homogeneous middleman groups (EHMGs) in Southeast Asia, Africa, and in Medieval Europe. These EHMGs have provided themselves with informal (cultural) norms of behavior which function as substitutes for formal contract law. Thus, my initial answer to the title of the paper is "generic"; b) to provide a theory of the EHMG as a low-cost club-like institutional arrangement for the enforcement of contract ; and c) to examine some implications of the theory for answering questions such as i) are underground economies non-discrimatory economies? ii) are underground economies the consequence of mercantilist policies? and iii) how to encourage indigenous entreprenership in undergound economies.

The paper is organized in four sections. Section I discusses the concepts of underground economy and the informal sector and suggests an alternative concept of a "shadow" economy to describe a special kind of underground economy. Section II provides empirical details of how the EHMGs in Asia Africa , and Medieval Europe cope with the problem of contract uncertainty in an environment where the legal framework for contract enforcement is not well-developed . Section III provides a theory of the ethnically homogneous middleman group, drawing on the New Institutional Economics. The concluding section will examine some of the implications flowing from the theory for clarification of certain issues arising from de Soto's paper andfrom the literature on informal sector.

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

Despite the emphasis on the existence of extra-legal norms as a key characteristic of the informal sector, de Soto did not provide a definition of the informal sector that captures that essential element. For de Soto, an "informal sector is composed of those people, who, although persuing legal ends, such as buying a home or operating a business, have not met all of the legal requirements to do so (p. 1)." To the extent that the definition of the informal sector emphasize behavior involving violation of certain legal rules, it is better to use the more desciptively accurate concept "underground economy" rather than the concept of "informal sector"—and de Soto uses the two concepts interchangeably— for two reasons:

a) First , the concept of informal sector is very elusive, and has been used by development economists and anthropologists to describe different activities within the informal sector(Compare, for e.g. Hart, 1973, Mazumdar,1976; Bromley 1978; Trager & Dannhaeuser, 1985). But none of the definitions of the informal sector that has been provided so far have

identified the informal institutional framework created by the informals in that sector as a key characteristic of the sector.

b) Second the term underground economy has been used to describe an economy in which behavior of participants involve violation of certain legal rules. Thus according to Tanzi " for some experts, underground economy represent almost exclusively the income that is not reported to tax authorities, regardless of whether such an income is, or is not, measured by national accounts (1982,p.ix).

Yet, even the notion of underground economy as it is presently understood is not sufficiently accurate to describe the imporance of informal institutions embedded in the underground economy. I therefore propose to coin a new concept —the shadow economy— by tracing the origins of the concept of informal sector to the work of P. T. Bauer, a pioneer in development economics.

Lord Bauer (1984), reflecting on his contribution to the early postwar development literature, noted that middlemen/trading activities were largely ignored by development economists, and when not ignored, middlemen were looked upon with disfavor. As a consequence, there followed policy proposals for the replacement of private trading arrangements by the establishment of state trading and state sponsored cooperative societies. These policies "had the unsurpising consequence of restricting the opportunities for producers and consumers and of entrenching inefficiency in the trading sector (p.38). Unsurprising to Bauer because, contrary to the thinking of early postwar development economists, he saw middlemen/trading activities as playing an indispensable role in the economies of S.E. Asia, and other LDCs that he has studied: the traders link the indigeneous producers with ultimate consumers and brought about a "more effective interregional and intertemporal allocation of output (p. 37). Continues Lord Bauer(p.38):

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

Thus if we trace the history of the genesis of the development of the concept of informal sector, it is clear that the sector which inspired the

emergence of the informal sector literature refers explicitly to the trading sector. The trading sectors in Southeast Asia, in East Africa, and in West Africa are dominated by the Chinese, the Indians, and the Lebanese traders respectively. As shall be described below, one of the key characteristics of these EHMGs is the group's capacity for self-governance: the ability to create for themselves the "rules of the game" based on their own cultural traditions, as subsitutes for formal contract law. Because of this capacity, these EHMGs can be said to operate "in the shadow of the law" (Mnookin and Kornhauser, 1979; Marc Galanter, 1981) ; I shall call such type of underground economy a shadow economy. Given the definition of a shadow economy as one in which the participants operate in the shadow of the law by creating functional eqivalents to formal laws, it is clear that:

a) a shadow economy is a subset of a more inclusive informal sector in that all participants in the shadow economy are also participants in the informal sector, but not all participants in the informal sector are necessary participants in the shadow economy;

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

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

II. The Shadow Economy of the EHMGs: The Role of Trust, Reputation, Cultural Norms, and Sanctions

This section will provide evidence that EHMGs function as "clubs" for the enforcement of contracts. We shall describe such clubs formed by Chinese middlemen in Southeast Asia, the Indians in East and Central Africa, the Lebanese traders in West Africa, and the Jews in Medieval Europe and elsewhere.

A. Chinese Middlemen in Southeast Asia

The marketing of smallholders' rubber in S.E.Asia is dominated by Chinese traders who function as middlemen between smallholders (largely indigeneous population) and ultimate overseas buyers. Members of the middleman group are arranged in a vertical marketing structure with division of labor among the different levels of middlemen. Village-dealers by far are the most numerous, buy rubber sheets from smallholders, grade and sell them to town dealers. Town-dealers, the next largest group, process and smoke the rubber sheets prior to resale to packer-exporters. Packer-exporters, at the apex of the marketing structure and located in ports like Kuala Lumpur, Penang, Malacca, and Singapore, sort, regrade and pack the rubber into bales for export to overseas consumers. In addition to this group, there are the remillers and the commission agents. The rubber dealers occupy an important economic position in the economy of S. E.Asia, given the importance of the rubber industry.

A closer scrutiny of the Chinese middleman group in Singapore and West Malaysia by Landa(1978, 1983) reveals the existence of a tightly knit ethnically homogeneous Hokkien-Chinese group and within the group six clans from Chuan-chow and Yung-chung in Fukien province in China--the Tan, Lee, Ng, Teh, Lim, and Gan clans--dominate the marketing network. The Hokkien ethnic community is the most wealthy and powerful of the five major Chinese ethnic groups (Hokkiens, Teochew, Cantonese, Hakka, and Hainanese) by virtue of their domance of the smallholders' rubber trade. Interviews with a number of Hokkien rubber dealers in Singapore and West Malaysia reveal the importance of the role of kinship/ethnic ties as a basis for establishing mutual trust and the informal sanctions that operate to enforce contracts.

According to Dealer 1:

> The way we Chinese operate in the rubber trade is that once a verbal agreement is reached, it is expected to be kept; it is based upon 100 percent mutual trust. Written legal contracts for us, are only a formality. We make a big transaction over the phone and sometimes we sign the contract, maybe a week later. But tomorrow, due to price changes, there may be profit or loss of $1,000 or one milion dollars; but the transaction has already been made over the phone and must be kept both parties. It is a matter of trust, very similar to operations in

the stock market; once transactions are closed, one doesn't change one's mind. If we know that a trader is well-known and reliable, we are prepared to do business with him. What Chinese call "ganching " is very much also a matter of "hsin-yoong" (trust). If I have confidence in a person, then I develop a "ganching"relationship with him. If I have "ganching with a person, I also trust that person.

According to Dealer 2:

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

And Dealer 3:

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

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

According to Yap Pheng Geck:

Chinese started being clannish. Besides being clannish, they also have locality ties. People from the same place in China club together to help each other. There is quite a lot of mutual help including extending credit to each other. Credit system among the Chinese is a loose system because there are no hard and fast rules. It is based purely on trust or "ganching" based on kinship ties and on long association. This mutual trust has been responsible for the collective success of the Chinese. The secret of Chinese success is mutual aid/mutual trust based on surname, family ties, clan ties,

> and so on. The Chinese have this kinship bond. They club together to help each other. I've seen it in all the Chinese communities I have visited—in Thailand, in Philippines, in San Francisco and in New York. This mutual trust means that the Chinese are very good at using credit; they seldom fail. We must not lose this spirit of mutual cooperation and become individualistic. We are individualistic in spirit, but collective in enterpise. If we are on our own, our resources are limited.

Or C.M.Wong:

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

Beyond the role of trust embedded in particularistic exchange relations, there are sanctions for punishing those who deliberatly breach the trust of their trading partners. In a cohesive Chinese ethnic community where dense face-to face communications networks exist, word gets around very quickly of anyone who deliberately breaks trust/promise. The result of gossip is that the offending party will be shamed—he will "loose face". The Chinese are very sensitive to "loosing face". As Yap Pheng Geck puts it:

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

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

> If a person has promised to sell certain goods at a stipulated price, he must sell the goods even if price has changed in the meantime. If a person breaks his promise/trust, then he will have to deal on a cash basis. This would be very difficult

> for a person with no capital or limited capital... When a business fails because of genuine losses, creditors may write off the debt if they feel that he cannot pay or they may accept composition if they feel he has some means to pay the debt. But if the person has been cheating his creditors, then the creditors will bankrupt him just to punish him.

Yap Pheng Geck puts it in another way:

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

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

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

Other researchers on Chinese middlemen in S.E. Asia have also emphasized the importance of mutual trust and the Chinese strategy of particularizing exchange relations as a way of establishing mutual trust. In his study of Chinese traders in Vietnam, Clifton Barton(1983,p.49) observed that:

> the most frequent explanation given by Chinese merchants for their success in business affairs was couched in terms of a single characteristic, in its Cantonese form is referred to as

> " sun yung." Chinese merchants were successful in direct proportion to the amount of "sun yung"they possessed. Vietnamese merchants failed to achieve the level of success attained by Chinese traders because they were generally lacking in" sun yung". Interestinly enough, Vietnamese merchants generally agreed to this explanation for their lack of success in competing with the Chinese.

Barton explained that "sun yung" means "trust" or "confidence" . When a person is said to have sun yung it means that the person has a reputation for trustworthiness, his word is his bond. People who can't be trusted have no sun yung. Contirues Barton:

> One of the main contentions of this paper is that the Chinese were able to succeed in Vietnam because they developed mechanisms for generating interpersonal trust and regulating business behavior in the absence of a well-functioning legal system. The Chinese approach to business was based upon verbal agreements relied soley on mutual trust--"sun yung"--backed by informal group sanctions. If a merchant was not trustworthy and reliable, that is, if lacked "sun yung", it would be impossible for him to do business. Once the fact that the merchant had failed to honour his word become know, other merchants would simply refuse to do business with him (p 53).

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

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

> The Chinese attitude towards debt and credit, two sides of the same coin, reflects their acquisitive ethic. Capital can only be made productive by investment and extension of credit is often the only convenient form for immediate investment of small amounts of capital, with high liquidity. This in turn reinforces the stress on friendship, trust, face-to-face relations and detailed knolwedge of the

> creditworthiness of the borrower because of the small size and short durations of most loans, combined with the lack of easy legal provision for chattel morgages, make most formal collateral impractical or impossible.

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

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

B. Non-indigenous EHMGs in Africa

The largest single foreign ethnic group involved in the African trade in the 1960s was the Indians. The Indians came from India to Africa through their early connections with Arabs and Portuguese, and especially with the British. Because of their historical ties with Britain, they are mostly found in Britich East and Central Africa than elsewhere in Africa. But they are not the only non-indigenous EHNGs operating in Africa: the middleman function in West Africa is performed by the Lebanese traders, while the Greeks predominate in Sudan and Congo.

B.1 The Indians in Central and East Africa

Central Africa consists of Rhodesia, Zambia and Malawi. In Rhodesia and Zambia, the middleman role is dominated by Hindu Indians coming from peasant families in the Gujarati region in India. The group is tightly knit, consisting of kinsmen bearing the name of Patel who belong to the Patidar caste. There is a high degree of internal solidarity among the Gujarati Indian merchants not only because of kinship ties but also of caste ties. The Hindu caste system is unique in that all members of Hindu society are born into a particular caste for which they have life-long membership and from which they cannot escape from their caste status. With no option to cross caste boundaries, this means that the Hindu caste code prescibes a high degree of mutual cooperation among caste members. The high degree of internal solidarity facilitate the Gujarati Indians in their middlemen roles. Dobson and Dobson (1968, p. 66) explain why Indians in Central Africa were successful in their middlmen roles:

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

The Gujarati Indians are especially prominent in the more profitable wholesale African trade where almost all sales are made on credit. How do Indians minimize credit default? Unlike the Europeans in Africa who resort to formal contracts in their business dealings, the Indians use the status of kinship, caste and religion in their dealings with each other to protect against credit risks. With increasing competititon from African traders at the retail level, Indians wholesalers are prepared to do business with African retailers, but they fear the risks of credit default. As Dobson and Dobson (19 p84) describe the situation:

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

C. The Lebanese Traders in West Africa

The Lebanese traders came to West Africa about 1900, around the same time that Indians came to settle in East and Central Africa. What account for the Lebanese success as middlemen? Dobson and Dobson (19 p.589),

comparing the Lebanese with the Indians, offer the following explanation:

> ...these two Oriental peoples were remarkably similar in those aspects of traditional culture and social structure that predisposed them to sucess in business. ..In both instances they came overwhelmingly from peasant families, but from peasants who possessed those indispensable 'personal and political connections' with traders already established in Africa. Both, for example, possessed a family system extended beyond the immediate 'nuclear' unit of parents and dependent offspring...Organizationally ...the small, tightly knit unit so created provides the foundation for cooperative action, capable of transcending the limitations of either capital resources or the functional capabilities of single individuals. Particularly when initial resources are small, this capacity gives such a group tremendous competitive advantages over isolated individuals (p. 589).

D. Jewish Merchants in Medieval Europe and Elsewhere

The Jews played a prominent role as middlemen/merchants in the Commercial Revolution of the Middle Ages. They formed a trading diaspora-dispersed trading communities —in which Jews cooperated with fellow Jews (co-religionists) in different parts of the interntional network. "Common ancestry, language and religion provided the basis for a moral community which could enforce ostracism" (Zenner, 1983,p.151) and this moral community played a crucial role in maintaining Jewish middlemen roles. As is well-known, Jewish religious life prescribes a dual strandard of ethics—i.e. fellow Jews are obliged to help each other but a Jew is not obliged to help an outsider; This dual standard of ethics fosters internal solidarity among Jewish merchants.

A closer look at a particular Jewish community in Jerba, Tunisia, provides further insights into the group-specific capacity of Jews to govern themselves(see Udovitich and [illegible], 1984). By the first half of 11th century, Jews in Jerba emerged as a well-established community. They participated in the commercial revolution of the Mediterranean world: they were engaged in trade that extended from Spain through Tunisia and Sicily to Eygpt and beyond to South Arabia and India. As part of the international network, they traded not only with co-regigionists from Tunisia and Eygpt but also with Italianian traders from Amalfi, Genoa and Venice who cme to North Africa to trade.

Within Jerba, the Jews dominated two occupations, textiles and the jewelry trade. It is precisely in the jewelry trade, where mutual trust is cricial between exchange partners, that "exchange b etween producers and merchant-distributors does not cross ethnic lines, but takes place between Jewish producers in Hara and their co-regionists merchant-distributors in the suq"(Lidovitch and Valensi, 1984). The mutual trust between merchants were based on Jewish cultural and legal traditions. The Jews are "people of the law" and adhere strictly to the law. These are revealed in the anedotes of their rabbis and holy men who emphaise reliability and faith(Hebrew: "Imun") and integrity (Hebrew : "Yashar") and these values are reflected in their economic dealings with each other. The same values of trust and integrity in business dealings, when extended across Jewish boundaries to economic transactions with Muslims becomes crystallised in the notion of "haqq al-yahud".

> Haqqal-yahud, the law and lawfulness of the Jews, is the basis for the trust they [Jerban Jews] enjoy in the economic sphere, especially in the jewelry trade (p. 29)... Haqq al-yahud imples a long list of qualities: skill and reliability in performing work, honesty in transactions and in keeping accounts. This notion summaries the good relations between buyers and sellers...It is primarily Jews who attribute to the haqq al-yahud their success in the market place. But even Muslims accept this image, beause it marks the limits which Jewish merchants cannot violate in their commercial practice (p.117).

Like the Chinese who emphasize the importance of "hsing yoong"/ "sun yung" in transactions as a key in contributing to their entrepreneurial success, so the Jerban Jews attribute the role of "haqqal-yahud" as playing an important role in their success vis-a-vis the Muslim population.

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

From the above descriptions of the various EHMGs in Southeast Asia, in Africa and in Medieval Europe, it is possible to identify the following general features of the EHMGs:

1.Multiciplity of middlemen operating at different levels of the marketing structure so as to form trading networks;

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

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

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

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

III. A Theory of the EHMG: The New Institutional Economics

The search for a theoretical framework for understanding the EHMG leads to Transaction Cost Economics, which is part of the New Institutional Economics. Central to the New Institutional Economics is the notion that "laws and institutions" matter in making possible the exploitation of gain-from-trade via their role in economizing on transaction costs. Coase's (1937) explanation of the nature of the firm laid the foundations of transaction costs economics. Transaction costs include costs of search for trading partners, costs of contract negotiation and enforcement. The institution of the firm, according to Coase, emerges to economize on costs of contract negoitation. Costs of enforcement arise from what Williamson (1975,1985) calls "opportunism"—"self-seeking with guile". Breach of contract is an example of opportunism.

The institutions of contract law and the vertically integrated firm, for example, are institutional arrangements to economize on costs arising from opportunisitic behavior. Landa (1976, 1987) has developed a theory of contract law which promotes middlemen entrepreneurship via its role in protecting a trader's "profit expectations". By assigning liability for damages to the breaching party, contract law reduces the incentive of a potential breaching party to breach his contract.

Williamson has shown that vertical integration is a solution to the problem of opportunism and is one of the two alternative modes of economic organization or "governance structures"—markets vs. hierarchies—for coping with opportunistic behavior in developed capitalist economies.

Arrow (1970) has identified yet another way society constrains opportunistic behavior: codes of behavior/ethics which establish trust between two parties who share the same code. The existence of trust economizes on transaction costs. Without trust, transaction costs mayt be so high as to lead to market failure. Arrow thus links up the concept of transaction costs with the concept of market failure. But despite Arrow's emphasis on the importance of trust in facilitating exchange, few economists have paid attention to the role of formal and informal norms in facilitating exchange. And, with the exception of economists of the Austrian and Public Choice schools, no economists has explained the emergence of social institutions, defined as "rules", rules that "refer to prescriptions commonly known and used by a set of participants to order repetitive, interdependent relationship. Prescriptions refer to which actions (or states of the world) which are required, prohibited, or permitted"(E> Ostrom, 1986, p.).

The Austrian approach provides an invisible-hand explanation of the emergence of social institutions, that is, institutions evolve as a result of market processes and other forms of spontaneous individual action. In other words, they emrge in an unintended manner without any conscious will directed toward their creation.

Public choice theory—the economics of politics—associated with the work of James Buchanan and Gordon Tullock (1962) — explains the conceptual origins of institutions in terms of a contractarian paradigm : (Buchanan, May 1976). Using a Prisoners' Dilemma paradigm, Buchanan showed that both actors, having found themselves in the Pareto-inferior position in that both were made worse by not cooperating than if they had cooperated, will enter into a "social contract" to choose the rules of the game to be enforced by the state. Institutions themselves can be seen as conceptually emerging from the public choice of individuals acting as rational hman beings who participate in both the eonomy and the polity/state.

When attention is shifted to developing economies, the EHMG reveals itself to be the dominant economic organizaiton, which is neither market, vertically integrated firm, or the state/contract law for the coordination of activities of middlemen across markets. And because attention is focused on the ethnic phenomenon of the middleman group, a theory of the EHMG must go beyond the New Institutional Economics to establish links with sociology and anthropology. What follows is a theory of the EHMG that links up several key concepts in the various social sciences.

Under conditions of contract uncertainty, a rational traders will not indiscriminately enter into impersonal exchange relations randomly with

anonymous traders. This is because at any particular point in time, an individual is embedded in social structures with rules of the game that serve to constrain his behaviour. Such a rational "embedded economic man" will enter into particularistic or personalistic exchange relations with traders whose reputation he knows to be trustworthy in honoring contracts. In order to choose a network of trustworthy trading partners, the trader will equip himself with a "calculus of relations" which enables him to rank all traders in a market according to a small number of categories corresponding to the degree of social relatedness or "social distance": the closer the social distance, the greater the degree of reciprocity, and hence the greater the degree of trust that a pontential trading partner will honor contracts.

The calculus of relations which helps the trader to establish the system of discriminatory ranking of trading partner presupposes that the trader can efficiently identify all potential traders and place them in their respective categories. In multi-ethnic societies, ethnicity is the most visible and reliable predictor of group membership. This is because there are three ethnic markers---physical appearance, language/dialect, and rituals (Landa, 1981; Carr and Landa, 1983)---which, when used alone or in combination, provide rapid low-cost clues of group identity.

The system of discriminatory ranking of traders can be represented by a series of Ego-centered concentric circles, encompassed within an ethnic boundary . Each circle represents a degree of relatedness or social distance. The smallest circle represents the small number of close kin. As Ego moes outwards, the circles become larger; so does the number of persons involved, but social distance declines. The ethnic boundary represents the outer limits of that group of near, distant kinsmen, friends, and fellow ethnics who Ego knows he can trust. Thus, when Ego chooses a least-cost network of trading partners, he will favor kin over nonkin, close kin over distant kin, fellow-ethnics over outsiders, as he moves from the center outwards towards the ethnic boundary.

For some traders, the Ego-centered trading network will become discontinuous or truncated at the ethnic/religious boundary: the trader will not transact across the boundary when the costs of contract enforcement with outsiders are perceived to be greater than the benefits of trading with outsiders. The costs of contract enforcement are especially high when outsiders are perceived by Ego to play by different rules of the game, which, in a trading context, include the contractual rules to honor one's obligations. For other traders who must cross the ehtnic/religious boundary in order to have access to the source of supply, the relevant comparison is the costs of enforcing contracts with outsiders--including the costs of using an

institutional mechanisms like cash transactions to cope with the problem of breach of contract--with the opportunity costs of exclusion of outsiders. The outcome of Ego's subjective calculus of relations in determining the objective mix of trading partners in the network therefore depend upon the number of members in the constituent concentric circles, the degree of heterogeneity of the population, and a balancing off at the margin between transaction costs of protecting contracts and the opportunity costs of exclusion of outsiders. Gien an interdependent, nondecomposable middleman economy, the structural effects of many individual middlemen's discriminatory rational choice of trustworthy traders is the emergence of an EHMG within the larger heterogeneous trading network.

The economic significance of the EHMG is that members of the same ethnic group form a moral community, sharing the same rules of the game so that norms of behavior embedded in middlemen personalistic exchange networks function to constrain traders from breach. Violation of the rules of the game result in individual and group sanctions being imposed on the offending party. Thus, cultural norms of behaviour embedded in the EHMG can be considered as "focal points" which faciliates the coordination of the activities of interdependent middlemen across markets. At the same time, cultural norms of behavior function as a screening device to screen out outsiders who do not belong to the same moral community of merchants.

The emergence of cultural norms of behavior embedded in the EHMG is by invisible hand process. But since the EHMG is a part of a larger ethnic/religious group with well-defined norms of behavior, norms which may have emerged hisotically via a public choice process, our theory, which combined an Austrian approach and the public choice approach, may be called a "reflexive theory of the emergence of norms."

Under conditions of contract uncertainty, kinship/ethnic status is a valuable intangible asset for a potential trading partner because of the "priority rights" Ego confers upon his trading partner; kinship/ethnic status is essential to middleman entrepreneurship. But the costs of obtaining this valuable asset are asymmetric for those who possess it and those who do not. Kinship or ethnic status is not a "right" that can be purchased by those who do not possess the requisite status. Status is acquired by virtue of a person being born into a particular kinship/ethnic group; thus kinship/ethnic status may therefore be regarded as a species of "status rights", the set of righs lying between the subset of private property and

common property rights. These rights are equivalent to rights of citizenship, including preferential access to job opportunities, but are accessible only to subset of the total population. Since status rights are nontransferable and nonmarketable by nature—it is human capital (in personam) assignment—the opportunity sets of traders are not the same in markets dominated by a particular kinship/ethnic group. Only those "insiders" who have the requisite status rights can become middlemen. The "outsiders", being de facto without status rights are excluded from middleman roles because they cannot obtain an essential nonmarketable asset necessary for middlemen-entrepreneurshipship . If industy conditions are favorable for expansion of these middleman activities, the value of status rights as an entry ticket into personalistic markets rises. Thus under conditions of contract uncertainty, "insiders" have a differential advantage vis-a-vis "outsiders in appropriating new middleman roles for themselves. Outsiders may try to compensate for the lack of status through investment in reputation and that is not costless. The transation costs of an outsider are higher than his counterpart who is an insider. The high transaction costs of outsiders constitute an entry barrier into personalistic middleman markets. Thus outsiders may be excluded from trading with middleman due to high transaction costs of acquiring reputation as a substitute for kinship/ethnic status. From the point of view of members of the EHMG as a whole, since they created the informal rules of the game for facilitating them in their middlemen entrepreneurial roles, the informal rules may be considered to be a public good/public capital for the whole group.

IV. Implications of Theory for Policy

A number of policy implications flow from our theory of the EHMG:

1. Fundamental role of Laws and Institutions : In order to promote economic development of LDCs, basic infrastructure must be provided. Far too often, development economists , politicans, and doners interested in giving aid to LDCs , concentrate too much on the visible infrastructures—the capital-intensive infrastructures(such as roads, bridges) and capital-intensive infrastructures (such as credit and financial institutions)—to the neglect of the institutional infrastructure. This is a mistake. The fundamental institutional problem is that of law and order. An economy must have a structure of rules—Adam Smith's "laws and institutions"—for protecting property rights and enforcing contracts. Without such a structure of rules, transaction costs may be so high as to impede the development of markets. Markets therefore must be supported by a system of laws and insitutions. Thus the institutional infrastructure, the invisible structure basic to the efficient functioning of markets, are the truly fundamental parts

of the infrastructure. Where the legal framework is not well-developed as in LDCs, only those who can perform the gap-filling function of creating for themselves informal law as substitutes for formal law can successfully become entrepreneurs. It is therefore not surprising to find that successful middlemen-entrepreneurship--which calls for a great deal of mutual cooperation because of long networks of interdependence among middlemen--are monopolized by ethnic groups who come from societies whose culture and social structure emphasis mutual aid and cooperation among those with well-defined relations via-a-vis each other. The fact that the EHMGs can function effectively in the "shadow of the law" indirectly points to the significant role of the formal law in promoting entrepreneurship and economic development. De Soto's work on the underground economies with their extralegal norms is therefore significant in emphasizing the crucial role of institutions in economic development

2) Size of the Shadow Economy/Underground Economy underestimated by using the cash criterion: The EHMGs function as credit economies;the trust among members of the group make it possible to extend credit to each other. Therefore measuring the size of the underground economy by using the cash criterion (e.g. Tanzi, 1982) underestimates the size and hence the importance of such economies in the larger setting.

3) The EHMGs as Discrimatory or Exclusive Clubs: Under conditions of contract uncertainty, a member of the EHMG either incur the opportunity costs of excluding outsiders from trade or the costs of using cash transactions across ethnic boundaries. For the outsider, without the requisite status, he must incur the costs of acquiring reputation; such costs may act as effective entry barriers. Consequently, the size of the trading group may be too small relative to an optimal size trading networt consisting of both insiders and outsiders (see Cooter and Landa, 1984). When a trading network is monopolized by non-indigenous population,with outsiders excluding insiders (the indigenous population) from participation in trade, that help to explain the hostility of the indigenous population towards non-indigeneous middlemen. The societal costs are the costs of racial conflict and violence in multi-ethnic societies. In de Soto's underground economies, those who are forced to cooperate on a tribal basis will of necessity exclude non-tribe members; is this a problem in Latin America?

4) Contract Law vs. Local Collective Action: Destroying these non-indigeneous trading networks by expulsion of middlemen--e.g. the experience in Indonesia in the 1960's and in Uganda in the 1970's--is not a viable solution because these non-indigeneous middlemen groups facilitate trade and economic development. One alternative to the formation of

discrimatory or exclusive clubs is to develop/improve contract law. Improvements in contract law reduce the size of ther EHMG and enlarging the size of the trading group which now becomes more heterogeneous because insiders have the incentive to cross ethnic boundaries to trade with outsiders. But developing/improving contract law to facilitate impersonal exchange between strangers itself creates new problems of its own. developing or imporving the efficiency of contract law has the same effect of "expropriating" the public good/public capital of the ethnic group that is able to create a substitute for formal law because improved contract law reduces the comparative advantage of the non-indigeneous middlemen group vis-a-vis the indigenous population. As Ireland puts it(1977):

> An adequate set of legal sanction would reduce costs of transactions between group members and non-group members, but it would also reduce the comparative advantage of group members as middlemen. If the group is small enough, their particular entrepreneurial advantage would be a scarce resource collecting quasi-rents that would be lost if adequate legal sanctions had the effect of increasing the supply of potential entrepreneurs. If the quasi-rents are more valuable to group members than lowered general transaction costs, adequate legal sanctions could not be Pareto-optimal without compensation.

A way out of this quandry may be to recommend local collective action on the part of indigenous population: to learn the lesson from the success of non-indigenous middlemen i.e. the the importance of developing a capacity for self-governance. For some indigenous groups (e.g. Malays in West Malaysia) this capacity for mutual cooperation may have to be self-consciously acquired in order to overcome the inherent instabililty of groups formed for long term economic cooperation.

Implications for A.I.D. — This informal sector is not target by AID intervention to the extent they operate outside the framework to wh A.I.D. relates.

— A.I.D. could encourage informals where these groups form segmented informal economies marked by ethnic/religious boundaries.

DRAFT

THE INFORMAL SECTOR, POLICY REFORM, AND STRUCTURAL TRANSFORMATION

by

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

with the assistance of Susan Coleman

I. INTRODUCTION

A. The Current Enthusiasm for Informal Sector Programs

Over the past several years, promotion of the informal sector has captured increasing attention among aid donors, political activists, and developing country governments. In the United States a remarkable political coalition, stretching from right to left on the political spectrum, has lined up behind the proposition that informal sector activities in the developing countries should be promoted more vigorously, notably by the United States Agency for International Development (AID). Conservatives see in this proposal opportunities for expanding entrepreneurship, creating jobs among the poor to help

ensure political stability, and stengthening the private sector, which they believe to be the true motor of economic development. Liberals support the same measures, seeing in them a grassroots, participatory way to help the poor, a means of generating self-sustained development among poor people to help them escape from poverty. Whether liberal or conservative, governments in many developing countries have become increasingly interested in the informal sector because of the large number of people to whom it offers a livelihood. At a time when many countries are experiencing severe economic dislocations, governments and aid donors alike are concerned about the political consequences of economic crisis and are considering promotion of the informal sector as one way to increase employment opportunities for poor people (see, for example, Sanyal, n.d.: 2-3).

This paper takes a somewhat critical view of this trend. After a brief discussion of AID's experience and views we lay out some objections and suggest an alternative viewpoint.

B. AID's Experience and Views

AID has been active in funding research and programs for assisting the informal sector in the 1980s. Its interest reflects the agency's perspectives that: (1) the private sector (both "formal" and "informal") is more efficient than the public sector in generating economic growth ; (2) support for informal sector activities will lead

to the reduction of poverty by increasing both employment and income levels in developing countries; and (3) support for informal sector businesses has a positive welfare impact on the poor and therefore is worthwhile as an end in itself.

First, AID considers its emphasis on the informal sector to be part of a world-wide trend to reduce the role of the public sector in national economies. It notes a growing movement, largely occurring within the past three to five years, to privatize industries, services, and agencies formerly controlled by the government, and argues that the state-owned sector is not effectively assisting the development process because of the enormous subsidies needed to maintain money-losing enterprises and services. Agency reports confirm a growing conviction that private entrepreneurs can manage industries more effectively and operate services at a lower cost to the pbulic than can government (Cowan, 1986). Furthermore, AID perspectives indicate that while there is a need for welfare programs in the short run, economic development, not "unending resource transfers," will assist the conditions of lack of income, hunger, illiteracy, disease, and early death. In its words, AID is interested in "development, not dependency" (AID, 1985: 14). Economic development will be enhanced by the "fullest use of market forces to promote basic needs objectives" (AID, 1985: 20).

Second, AID considers the informal sector to be a most significant source of job and income creation, especially for the disadvan-

taged (Ashe, 1985: 134). The Agency estimates that some 780 million new jobs need to be created in developing countries by the end of the century. According to AID reports and position papers, it is the street vendors and micro-level industries and services that will generate the majority of new employment in the future, not large-scale factories. The argument is that these businesses have low capital requirements, provide requisite flexibility for women to build their work hours around child care, permit product lines to be shifted around quickly to meet consumer demand, and avoid many regulatory boundaries, such as licensing, safety inspection, and taxes. In addition, urban migrants have the knowledge to start these types of businesses and do not have the necessary skills, education, and training to establish larger enterprises. Moreover, AID publications argue that informal sector businesses provide goods and services to the poor at prices they can pay and in amounts they can use. In addition, informal sector businesses are said to improve the utilization of the nation's capital stock by facilitating informal credit flows and to create employment indirectly through backward linkages to farmers and forward linkages to modern manufacturers (Ashe, 1985: 4-9).

Thus, an AID-financed study (Ashe, 1985) argues, "(t)he case for assisting the informal sector is a powerful one." According to this study, the informal sector is the fastest growing sector in some developing country economies and currently constitutes 80-90 percent of all business units existing within a typical poor neighborhood in a

developing country. Indeed, because of massive rural-to-urban migration in recent decades, the number of informal urban enterprises is increasing, both in absolute numbers and as a percentage of the labor force (Ashe, 1985: 1). "Quite simply," the report asserts, "the informal sector is too important to be ignored. That these economic enterprises provide the bulk of goods and services for the poor, the great majority of job and skill training, and virtually all the entrepreneurial opportunities for women, are additional reasons for assisting the sector." (Ashe, 1985: 11). This report also cites studies demonstrating that "in terms of increased national income, assistance to microenterprises is one of the most successful categories of AID assistance. Program planners can calculate that one business can be assisted for every $100 to $300 of loan funds available, that loans will increase income from ten percent to 100 percent, and that a new job will be created for every $1,000 in credit extended" (Ashe, 1985: 12).

Finally, AID documents appear to endorse the view, to a more limited degree than the arguments set forward above, that working with the poor is a goal in itself, not only for the creation of income and employment but for promoting an equitable society and strengthening the underpinnings of democracy (Ashe, 1985: 128).

In spite of the avid support for informal sector business, AID recognizes that "changes in income must be related the the health of the economy. If the economy is improving, or at least stable, small

informal sector businessmen will thrive -- if the economy is in a period of severe recession, the street economy will be affected adversely as well" (Ashe, 1985: 43). To this end, AID recognizes that inappropriate macro and microeconomic policies hurt poor people and limit economic prospects. Therefore, they believe it is essential that, for example, adequate prices be set to stimulate food production and exchange rates be established that do not unduly distort the price structure (AID, 1985: 16-17).

C. The Definitional Problem

In this paper we will subject the prevailing orthodoxy to a critical reexamination. The first issue to be considered is the definition of the informal sector itself. We argue that the term "informal sector" is a heuristic device at best. According to the International Labor Office's 1972 report on Kenya, which is widely credited with popularizing the term, "informal activities are the way of doing things, characterized by--

(a) ease of entry;

(b) reliance on indigenous resources;

(c) family ownership of enterprises;

(d) small scale of operation;

(e) labor-intensive and adapted technology;

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

(g) unregulated and competitive markets."

They add that, "Informal-sector activities are largely ignored, rarely supported, often regulated and sometimes actively discouraged by the Government."

The other side of the dichotomy was defined by the ILO mission as follows. "The characteristics of formal-sector activities are the obverse of these, namely--

(a) difficult entry;

(b) frequent reliance on overseas resources;

(c) corporate ownership;

(d) large scale of operation;

(e) capital-intensive and often imported technology;

(f) formally acquired skills, often expatriate; and

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

Problems arise as a result of the bundling together of all these characteristics. Athough there is obviously some tendency for them to be found together, this is not always the case. For example, those who emphasize the status of the enterprise in relation to law and regulation insist that size is no criterion; by their definition, informal sector firms may be quite large. But others put the emphasis on enterprise size, usually measured by the number of workers involved. Ray Bromley (1978, pp. 1034-1035) cites no fewer than nine "particular

deficiencies that are worth mentioning" in "the informal/formal classificiation, as commonly depicted in the literature...":

1) it forces all economic activity into two categories, when a larger number would give each category considerably more internal coherence;
2) it implies that all the listed characteristics occur together, while giving no indication of how firms that have some of the characteristics of the informal sector and some of the formal sector should be classified;
3) it suggests that the two sectors are essentially separate and independent, rather than interacting;
4) it leads to the mistaken belief that a single policy prescription can be applied to the entire sector, when in fact different mixes of incentives, assistance, neglect, rehabilitation, and persecution might be appropriate for different activties within it;
5) there is a tendency to regard it as exclusively urban, when many of the same activities occur in the rural areas as well;
6) it is unclear what else exists besides the "formal sector" and the "informal sector"; where do the state, executive/professional activities, the rural economy fit in?
7) defining the informal sector in terms of lack of govern-

ment support leads to its simplistic definition as a "target group" and suggests that introduction of government support would be a virtual guarantee of its success;

8) there is a tendency to confuse neighborhoods, households, people, and activtities with enterprises; many people work in "informal" enterprises at certain stages in the life cycle, seasons of the year, etc. and in "formal" enterprises at others; similarly, neighborhoods often have a mix of activities;

9) there is a tendency to consider "the urban informal sector" and "the urban poor" as synonymous; in fact, many who work in the informal sector have higher incomes and no less job security than those who occupy the lower rungs of employment in formal sector enterprises.

Among those who find the informal sector concept useful, the essential debate is over whether informal sector workers are most appropriately viewed in negative terms as a passive, exploited majority -- the older view -- or more positively as an autonomous capacity for generating growth in the incomes of the urban poor -- as has been increasingly argued in recent years (ILO, 1972; Farbman, 1981; De Soto, 1987). For those who take the positive view, the next question is what policymakers can best do to realize the perceived potential: Introduce credit and other assistance programs? Eliminate laws and

regulations that inhibit informal sector activties? Go further, and introduce policies that actively favor the informal sector?

D. An Alternative Viewpoint

Moving beyond the formal-informal dichotomy, we present in this paper a viewpoint on these issues which differs in what we believe are productive ways from those put forward previously. Briefly put, our aim is to place discussion of the informal sector more firmly within a widely accepted framework of the process of economic development. The purpose of the argument is to provide guidance to those involved in policymaking: to policymakers within LDC governments, groups within LDC societies wishing to take part in the policy debate, international aid organizations, interested citizens everywhere. To assist the reader, we will close this introductory section by summarizing our main points.

For countries at low and middle levels of per capita income, substantial improvement in living standards requires economic growth, which may be viewed as essentially the raising of average income levels. All the important indicators of social welfare are positively correlated with per capita income; in most cases the degree of correlation is high. The distinguished research of Kuznets (1965; 1966) and Chenery (1979; Chenery and Syrquin, 1975) demonstrated conclusively that, except in countries which possess fabulous mineral wealth,

economic growth requires structural transformation. The essence of structural transformation is a rise in the importance of the industrial sector, both in absolute terms and as a share of aggregate value added and employment. As structural transformation occurs, the importance of the agricultural sector declines. The third broad sector of the economy, services, may either rise or fall as a share of total production and employment.

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

Structural transformation within the industrial sector has two components: a "labor reallocation" component, in which people who are working on their own or in small enterprises eventually find higher-paid jobs in larger firms, and an "enterprise growth" component, in which a very small number of small enterprises grow into the middle and larger size categories. Quantitatively, the "labor reallocation"

component is by far the more important. As emphasized in the "dualistic" models of Lewis (1954) and Fei and Ranis (1964), development occurs largely through the shift of labor to more productive forms of employment. As not stressed by these theories, these shifts take place not just between agriculture and industry but also within the industrial and service sectors. Although smaller than the "labor reallocation" component, the "enterprise growth" component is also significant. A dynamic economy permits successful small firms to grow into the middle size category and middle size firms to become large. While most small firms fail after a few years or remain stagnant, merely earning a living for their proprietors, a few grow and add an important element of dynamism to the economy (Brit study, 1986).

Although there are "normal" or average patterns that tend to apply to countries as particular levels of per capita income, there are also variations among countries at similar income levels. Some of these are caused by differences in "givens" such as natural resource endowments. Other intercountry variations result from differences in economic policy. Many LDCs exhibit the extreme dualism in the distribution of industrial sector employment in terms of enterprise size which we call "the missing middle." We attribute this to policies which favor the largest firms, on the one hand, and in some cases also the smallest ones, on the other. Although we do not believe that enterprise size provides a satisfactory basis for discriminatory policy measures, this type of industrial policy can be harmful because it

creates a "small firm growth trap" and inhibits the "enterprise growth" component of structural transformation. To shift labor to higher productivity activities, it is necessary to promote growth and labor demand. This in turn requires promotion of the most productive growth agents in the economy.

Even if the GNP of Bangladesh, Burkina Faso, or Bolivia could be distributed in exactly equal proportions to the citizens of those countries, they would still be very poor. The only way to overcome their poverty is through economic growth, and this requires structural transformation. In relation to small firms or the "informal sector," this suggests that efforts to raise income and productivity among these categories generally through policy or programmatic means are not likely to raise income very much. The only thing that will do that is structural transformation which moves labor from less productive activities to more productive activities and permits the progressive minority of small firms to grow.

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

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

Third, however, policy must go beyond mere neutrality -- sometimes called "the level playing field" -- to active promotion of potentially dynamic firms. No country yet has developed on the basis of policy neutrality, despite its frequent advocacy. To fill in "the missing midlle," countries must be able to (a) formulate policies that are performance based and permit progressive dynamic small and medium sized firms to, in effect, identify themselves, and (b) provide the forms of assistance that will help them grow. How to accomplish these two tasks is not yet altogether clear, but the general principle is

that what is needed is not policy neutrality but policies which favor firms which turn in favorable performances.

II. THE INFORMAL SECTOR AND STRUCTURAL TRANSFORMATION

A. Implications of the Definitional Problem

1. It's Difficult to Formulate Policy Objectives for an Ill-defined, Ever-changing Policy Target

It is clear from the nature of the ongoing debate that no real clarity or agreement exists about what exactly constitutes the mixed bag of phenomena labeled "the informal sector." As Richardson has pointed out in a review of the literature, notwithstanding hundreds of academic pages devoted to the task, popularizers of the informal sector concept have been "unable to come up with a definition precise enough to be useful for analytical or operational purposes" (Richardson, 1984). The central problem is, as already mentioned in the introduction to this paper, that meaningful grouping of the large and diverse economic activities outside "formal" employment is almost impossible. No definition can adequately capture all the nuances.

One consequence of this problem is a certain self-serving flexibility in definitions. Many studies adopt a definitional approach

that favorably emphasizes the main themes argues by the author. In general, most definitions circumscribe boundaries of the informal sector by what might be called the "characterisitics approach." Particular characteristics of putative informal sector participants are spelled out in order to "tag" active members. Researchers most directly interested in employment issues generally take up the worker' characterstics definitional approach (for example, informal section workers are tagged as all itinerant workers, workers without a fixed work place, casual workers, or workers who do not contribute to a social security system), while those focusing on firm issues adopt the enterprise characteristics approach (for example, firms of a particular size group, or firms using a particular technology). Still others favor wider scope and incorporate different characterisitic of the formal and informal economic and institutional environment: some studies emphasize market characteristics which predominate in informal activities (ILO, 1972), while others concentrate on legal characteristics of informal transactions (outside government regulations and control; De Soto, 1987) or outside modern contractual relations (Portes, Blitzer, and Curtis, 1986).

Presented with an enormous quantity of research with differing results depending on the definitional approach adopted, both policymakers and development practitioners find it difficult to respond appropriately to calls to stimulate the growth of the informal sector. It is next to impossible to target that which cannot be defined. Is

it workers or is it firms that policymakers should worry about? Is it the broad aspects of poverty which should be directly targeted? Or is it the institutional setting that deserves most attention -- namely government regulatory agencies abd tge legal system?

2. So Why Not Drop the Idea of the Informal Sector and Concentrate on What We Really Have in Mind?

The real reason for our interest in "infomal" economic activity in developing countries is not so much that informality itself holds great importance. Rather, it is that these activities tend, on the whole, to exhibit low productivity (Peattie, 1980).[1] The problem is that during the course of economic growth and transformation in many LDCs certain segments of the work force and enterprise population are relegated to, and seem to get stuck in, relatively low productivity economic activities in industry and services. To answer question such as what is the informal sector, what does "it" do, and, most important, what to do about "it," one must address the central cause of the structural transformation problem. This cannot be done by studying "informal" activities (however defined) in isolation from the rest of the economy. The nature of the problem of distorted structual transformation requires a more wholistic, evoltionary analytical framework. What are the major determinants of the <u>nature</u> and <u>speed</u> of structural

transformation in various sectors? How do market and policy-induced failures affect the outcome?

We propose that the concept of the informal sector be dropped for the time being in order to focus more clearly on the causes and consequences of the general phenomenon of low productivity employment. Empirical data indicate that the picture of "distorted" and/or "unsuccessful" structural traansformation is sketched out in both the labor market and the size distribution and productivity of industrial enterprises. The remainder of this paper will be devoted to an analysis of these two segments of the low productivity employment problem. As the focus of this seminar is Latin America, the data we use are largely drawn from this region.

B. Employment Aspects of the Problem

1. Employment Growth and Urban Surplus Labor

Is there an <u>unemployment</u> problem Latin America and, more generally, in the LDCs? Has over-urbanization contributed to the marginalization (or under-employment) of large segments of the economically active population in the urban areas? On the demand side, has modern industrial labor absorption been too low (for whatever reasons) to soak up the burgeoning urban work force? Finally, has low industrial labor absorption been the central cause of increased "informal," low-

productivity employment in urban areas? These questions underlie some of the central concerns about the low productivity urban work force and what to do about it. Answers may help us see the problem of informality in urban labor markets more clearly.

The most popular explanation for the existence and putative expansion of "informal" employment in Latin America in the last several decades is that "formal" segements of modern industry have absorbed labor too slowly. That is, rapid urbanization and low industrial labor absorption have created a situation in which the portion of the labor force which cannot be employed in the modern sector has to generate its own income in low productivity activities rather than become openly unemployed (Mazumdar, 1975; Souza and Tokman, 1976; Sethuraman, 1977; et al.). An examination of structural changes in employment is instructive in assessing this assertion.

2. Static Comparison of Structural Change in Output and Employment

If we compare Latin American countries with the "standard pattern" of structural change in developing nations (based on examination of cross-country comparisons at various levels of income per capita), the most striking difference in employment structure to be noted is the relatively low share of work force in agriculture (Table 1).[2] Almost all countries in Latin America deviate significantly from

the international standard pattern, in terms of both value added and employment in primary production. Particularly for employment, deviations from the rest of the world are large in the Southern Cone, Colombia, Peru, and Bolivia. Mexico, surprisingly, deviates on the high side, probably as a result of extensive land reforms over the years. Related to this low agricultural share is an unusually high rate of urban labor force growth. In Latin America as a whole, while the entire economically active population grew at an annual rate of 2.5 percent between 1950 and 1980, urban labor force grew half again as fast, at 3.8 percent (Table 2). Divergence of the urban share of employment from the standard pattern is particularly significant again in the Southern Cone, and in Peru, the Dominican Republic, Bolivia, and Nicaragua. On average, Latin America has become one of the most urbanized regions in the world. As a region, it exceeds the standard pattern of urbanization for any given level of income per capita by 14 percentage points (Syrquin, 1987).

Since the percentage of employment in industry in Latin American does not differ much from the standard pattern (except in Venezuela, Argentina, and Chile), increasing pressure has been put on the services sector to soak up much of the large work force shifting out of agriculture. Thus, in most Latin American countries one would expect current employment in services to diverge on the high side from the standard; Table 1 confirms this expectation.

TABLE 1

ECONOMIC STRUCTURE IN LATIN AMERICAN COUNTRIES

COMPARED TO THE INTERNATIONAL PATTERN FOR 1950-1983

(Average residuals for the whole period)

A. TRADE AND FINAL DEMAND (% OF GDP)

	Exports	Primary exports	Manufactured exports	Manufactured imports	Government consumption	Gross domestic investment
Venezuela	2	14	-10	-3	-2	5
Mexico	-9	-8	-5	-5	-5	-3
Argentina	-14	-7	-5	-10	-3	-3
Uruguay	-21	-11	-8	-17	-4	-11
Brazil	-9	-6	-3	-6	-2	1
Panama	0	--	--	--	-2	-4
Costa Rica	-8	-4	-4	-2	-3	-5
Chile	-12	-2	-7	-9	-3	-10
Peru	-7	-3	-5	-6	-3	-2
Paraguay	-20	-12	-5	-13	-8	-6
Dominican Rep.	-10	-6	-4	-8	-4	-5
Colombia	-8	-6	-3	-6	-5	-3
Ecuador	-9	-1	-6	-5	-3	-4
Guatemala	-12	-6	-2	-6	-7	-8
Bolivia	-11	-2	-4	-5	-5	-6
Nicaragua	-7	0	-5	-3	-5	-7
El Salvador	-4	-1	1	-2	-4	-7
Honduras	-3	4	-3	1	-4	-4
Mean	-9	-3	-5	-6	-4	-5

B. EMPLOYMENT AND URBANIZATION

	% of employment			% of population
	Agriculture	Industry	Services	Urban share
Venezuela	-3	-6	9	18
Mexico	5	-3	-2	7
Argentina	-27	7	20	30
Uruguay	-19	3	16	29
Brazil	-4	-4	8	9
Panama	-7	-3	10	7
Costa Rica	-5	-1	6	-2
Chile	-17	-6	23	25
Peru	-6	0	6	15
Paraguay	-6	3	3	1
Dominican Rep.	1	-2	1	4
Colombia	-15	2	13	15
Ecuador	-5	3	2	1
Guatemala	2	0	-2	0
Bolivia	-7	6	1	10
Nicagaua	-2	-1	3	15
El Salvador	-5	4	1	8
Honduras	1	0	-1	2
Mean	-7	0	7	11

C. VALUE ADDED (% OF GDP)

	Agriculture	Services	Manufact.	Manufact. disagregated* Early	Middle	Late
Venezuela	-6	-3	-6	-3	1	-5
Mexico	-5	12	0	2	0	-2
Argentina	-5	-1	9	--	--	--
Uruguay	-1	6	6	6	3	-3
Brazil	-5	9	5	1	2	3
Panama	-8	19	-1	1	0	-1
Costa Rica	3	8	4	4	2	-2
Chile	-9	7	5	1	-1	3
Peru	-10	8	8	3	1	1
Paraguay	7	2	5	4	2	-1
Dominican Rep.	-5	8	5	7	-1	-2
Colombia	2	0	1	2	0	-2
Ecuador	-5	7	4	3	1	-1
Guatemala	--	--	--	2	0	-1
Bolivia	-10	7	3	3	-1	-1
Nicaragua	-1	9	5	2	0	0
Honduras	2	0	4	--	--	--
Mean	-3	6	4	3	1	-1

*Early: Food, textiles and clothing, and miscellaneous
Middle: Wood, rubber, chemicals, and nonmetalic minerals.
Late: Paper and printing, basic metals, metal products, and machinery

Source: Syrquin (1987).

TABLE 2

GROWTH OF POPULATION AND EMPLOYMENT
IN LATIN AMERICA, 1925-1980
(Average annual growth rates, %)

	1925-1950	1950-1970	1970-1980
POPULATION			
Total	2.2	2.8	2.5
Urban	3.5	4.4	3.8
ECONOMICALLY ACTIVE POPULATION			
Total	2.0	2.3	3.0
Primary	1.4	1.0	1.1
Non-primary	2.9	3.6	4.2
"Formal" (industry)	---	3.7	4.1
"Informal"*	---	1.5	2.1

Source: Ramos (1984), based on ECLA (1965) and PREALC (1982).

*"Informal" is defined generally as self-employed plus unpaid family workers.

3. Dynamic Comparisons of Structural Change in Output and Employment

An investigation into the dynamics of structural change adds to the picture presented by these static relationships. Table 3 contains coefficients which measure the association of economic structure with changes in income per capita as development progresses. The coefficients of the income slopes for employment in agriculture, industry, and services measure the strength of structural change with respect to income per capita (but not necessarily with respect to time). The data show that structural transformation of employment has been more pronounced than the transformation of production in Latin America since 1950. Table 3 shows that, as per capita income increased, a very substantial reallocation of labor from agriculture to industry and services took place. The developed countries took twice as long to accomplish a similar transformation (Tokman, 1982). The difference is not attributable to any greater strength of structural transformation in the case of Latin America; the coefficient for agriculture was -.24 in Latin America, compared to -.27 in the developed countries. Rather, the explanation lies in a sharp difference in overall growth rates. Developed countries grew at an average rate of 1.3 percent perannum in 1870-1950, the period used for the comparison, while Latin American countries averaged growth of 3 percent a year in 1950-1980 (Maddison, 1980).

The evidence indicates that one-quarter of the large amount of labor shifted out of agriculture in Latin America went to the industrial sector (comprising mining, manufacturing, construction, and public utilities) and three-quarters went to services. This rate of labor absorption in industry is a bit lower than the average for upper- and middle-income countries (Table 3), which absorbed about one-third of the shifting rural labor force into industry. Among Latin American countries, labor absorption in industry was particularly slow in Argentina, Chile, Peru, and Colombia. Of course, the reallocation of labor to services as structural transformation proceeds is no surprise. Thirty years ago Kuznets found that "...in most countries the substantial decline in share of agriculture is compensated by a substantial rise in share of services, not by a rise in share of industry" (Kuznets, 1966, p. --). What is surprising is the slower decline of agriculture with respect to per capita income (on average) in Latin America relative to the historical experience for developed countries, particularly given the concern in Latin America about its anomalously high rate of urbanization. Faster income growth is the culprit, not structural problems. Also surprising is the slightly lower share of shifting labor force taken up by industry. As we discuss later, this may have more to do with statistical anomalies

TABLE 3

TIME SERIES ESTIMATES OF INCOME SLOPES

A. VALUE ADDED

	Current price shares			Constant price shares		
	Agricult.	Manufact.	Services	Agricult.	Manufact.	Services
Venezuela	-.02	.11	-.09	-.03	.04	.18
Mexico	-.11	.02	.01	-.08	.08	-.07
Argentina	-.16	.05	-.01	-.15	.05	.10
Uruguay	-.13	.01	.14	-.04	0	-.05
Brazil	-.05	.02	.03	-.08	.03	-.01
Panama	-.11	.03	-.04	-.12	.04	-.04
Costa Rica	-.10	.08	-.02	-.11	.15	-.12
Chile	-.06	.08	-.10	-.06	.08	.07
Peru	-.30	.08	.08	-.18	.12	.02
Paraguay	-.11	.01	.05	-.12	0	.01
Dominican Rep.	-.11	.03	-.03	-.16	.04	-.04
Colombia	-.20	.04	.11	-.14	.04	.04
Ecuador	-.17	.02	-.10	--	--	--
Guatemala	--	--	--	--	--	--
Bolivia	-.17	-.05	.02	-.08	.04	-.05
Nicaragua	.01	-.02	-.02	-.09	.12	.01
El Salvador	-.13	.08	.05	-.20	.12	.01
Honduras	-.52	.19	.06	-.31	.13	.15
Mean slopes						
Latin America	-.14	.05	.01	-.12	.06	.01
Low-Y countries	-.24	.06	.09	-.19	.07	.08
Lower middle Y	-.17	.05	.03	-.14	.04	.05
Upper middle Y	-.12	.03	0	-.11	.06	.02
Industrial	-.09	-.05	.16	-.05	.03	.02

B. EMPLOYMENT

	Agriculture	Industry	Services
Venezuela	-.34	.08	.26
Mexico	-.26	.09	.17
Argentina	-.19	-.13	.32
Uruguay	-.30	.10	.20
Brazil	-.22	.09	.13
Panama	-.21	.04	.17
Costa Rica	-.34	.07	.27
Chile	-.21	.01	.20
Peru	-.21	0	.21
Paraguay	-.11	.01	.10
Dominican Republic	-.25	.08	.17
Colombia	-.46	.05	.41
Ecuador	-.07	-.02	.09
Guatemala	-.22	.10	.12
Bolivia	-.26	.13	.13
Nicaragua	-.30	0	.30
El Salvador	-.29	.14	.15
Honduras	-.28	.27	.01
Mean slopes			
Latin America	-.24	.06	.18
Low income countries	-.10	.05	.05
Lower middle income countries	-.20	.07	.13
Upper middle income countries	-.22	.08	.14
Industrial countries	-.18	.01	.17

C. TRADE AND INVESTMENT

	Exports				Investment	
	Current price	Constant price	Primary exports	Mfrd. exports	Current price	Constant price
Venezuela	-.05	-.28	0	-.01	0	.09
Mexico	-.02	-.01	-.01	.01	.09	.09
Argentina	.01	.01	-.02	.05	.17	.09
Uruguay	.08	--	-.08	.11	-.01	--
Brazil	.01	.01	-.01	.03	.01	.04
Panama	--	--	--	--	.18	--
Costa Rica	.17	.24	.02	.11	.15	.12
Chile	-.10	-.07	-.13	-.02	.19	.24
Peru	-.04	-.10	-.31	.05	-.16	-.10
Paraguay	-.07	-.06	.01	.01	.21	.32
Dominican Rep.	-.03	-.03	.02	.06	.16	.19
Colombia	.03	-.06	0	.05	.05	-.03
Ecuador	.10	.14	.13	.01	.14	0
Guatemala	.15	.14	.07	.06	.14	.04
Bolivia	.18	-.04	.17	0	.21	.19
Nicaragua	.03	.14	0	.05	.15	.16
El Salvador	-.23	.22	.24	.13	.21	.18
Honduras	.39	.37	.37	.12	.33	.33
Mean slopes						
Latin America	.08	.04	.01	.06	.14	.12
Low-Y countries	.05	0	-.02	0	.16	.12
Lower middle-Y	.11	.09	.09	.04	.14	.12
Upper middle-Y	.10	.07	0	.11	.12	.13
Industrial	.08	.20	.01	.12	.02	0

Source: Syrquin (1987).

than with a real difference between Latin America and the rest of the world.

4. The Rate and Structure of Urban Industrial Labor Absorption

Does the large observed shift of labor force from agriculture to urban tertiary employment in Latin America imply a failure of modern industry to expand employment opportunities? Although we have seen that Latin American industry on average took in a slightly smaller percentage of the labor force shifted from agriculture than the average for middle income countries, evidence indicates that the answer to this question is, in most cases, no. In general, annual growth rates of industrial employment kept pace with growth rates of the nonagricultural economically active population between 1950 and 1980 (see Table 2).[3] These growth rates, in fact, were analogous to those of more developed regions during their periods of rapid structural change and development (Kuznets, 1966; Tokman, 1982). A number of countries did even better than the regional average: in Brazil, modern industrial employment grew at an average annual rate of 4.5 percent in the three decades after 1950, while in Mexico the comparable average was 5.5 percent. Pulling down the regional average were countries such as Peru (0.7 percent average annual growth) and Chile (1.9 percent) (Table 4).

92

There is no doubt that annual rates of industrial growth and employment in most countries in Latin America could have been even better. Over a comparable period East Asian countries recorded average annual rates of industrial employment as high as 6 percent (Table 4). Even so, although none of the Latin American countries matched Taiwan, the leader in East Asia, both Mexico and Brazil had average growth rates of industrial employment that rivaled or exceeded Korea's.

The main reason for Latin America's less than optimal performance was its trade orientation. Trade levels in the region fall well below predicted values for countries at similar levels of development (Tables 1 and 3). Latin American countries on the whole participated in only a limited way in the explosion of world trade in the post-war period. Most of the region followed a classic import substitution strategy. Some economists argue that the protectionist policies which have been used to implement this strategy, particularly for heavy industry, have been "only a preamble to a future export stage, providing the learning required before reaching out for markets abroad" (Teitel and Thoumi, 1986, p. 486). But even if this is so for the long run, evidence shows that the short-run employment trade-off

TABLE 4

EMPLOYMENT ELASTICITY OF OUTPUT IN LATIN AMERICA, KOREA, TAIWAN, AND THE PHILIPPINES

Country	Period	Annual Average Growth Rate in Manufacturing: Employment	Annual Average Growth Rate in Manufacturing: Value Added	Employment Elasticity of Output
		Selected Latin American Countries		
Agentina	1950-60	2.1	4.1	0.51
	1960-70	-0.1	5.6	-0.02
	1970-80	1.1	1.6	0.69
Brazil	1950-60	3.3	9.1	0.36
	1960-70	3.4	6.9	0.49
	1970-80	6.9	9.2	0.75
Chile	1950-60	0.7	4.7	0.15
	1960-70	3.1	5.3	0.58
	1970-80	2.1	1.4	1.56
Colombia	1950-60	2.4	6.5	0.37
	1960-70	5.8	6.0	0.97
	1970-80	0.3	5.6	0.06
Mexico	1950-60	3.9	6.2	0.63
	1960-70	5.8	9.1	0.64
	1970-80	7.0	7.2	0.97
Peru	1950-60	0.3	0	0.04
	1960-70	0	5.8	0
	1970-80	1.7	3.4	0.50
Korea	1960-70	16.4	32.6	0.50
	1970-80	9.0	34.4	0.26
	1980-85	3.3	2.9	1.14
Taiwan	1956-60	4.4	20.7	0.21
	1960-70	6.4	20.3	0.32
	1970-80	8.4	22.8	0.37
	1980-85	3.1	10.0	0.31
Philippines	1956-60	1.0	13.8	0.07
	1960-70	2.5	12.3	0.20

1970-80	3.4	21.5	0.16
1980-85	0.8	18.6	0.04

Source: For Latin America: Annuario Estatistico de America Latina y El Caribe (ECLA, 1985).
For Korea, Taiwan, and Philippines:

has been substantial in some cases. Inward-oriented strategies, favoring the production of import competing goods at the expense of exportables, are much less (unskilled) labor intensive (Kreuger et al., 1983). There also seems to be a significant interaction between import substitution strategies and factor market price distortions, leading to high capital/output ratios and reduced demand for labor. In addition to these static effects, dynamic effects on employment can occur, owing to the positive association between rates of growth and labor productivity (Kreuger et al., 1983; Chenery, Robinson, and Syrquin, 1986).

In other important areas, such as gross domestic investment, Latin America fits the "normal" pattern. As a region, it increased its investment rates (with respect to income) at a pace similar to that of other developing countries (Tables 1 and 3). Only Peru was abnormally low in this respect. Further, if we compare a developed country like the United States in its early period of growth -- say 1870 to 1906 -- with Latin America in 1950-80, average investment rates are similar: about 20 percent of GDP.

5. The Problem of Structural Heterogeneity

A troubling feature of urban labor absoprtion in most Latin American countries is the amount of structural heterogeneity. A large segment of the urban economically active population works in rela-

tively low productivity activities, side-by-side with high productivity "modern" activities. This indicates that efficient structural transformation is not taking place, effecting a shift of workers from low-productivity work to higher productivity economic activities. As a result, the conditions of employment are stagnating and perhaps worsening for a large segment of urban work force. The central cause of structural heterogeneity, particularly its persistence over time, is inappropriate public policy.

By structural heterogeneity of the urban work force, we mean the existence of a large segment of the urban economically active population in relatively low productivity "informal" activities and some "informal" activities side-by-side with high productivity "formal" activities, <u>particularly in the same sector</u>. By the early 1980s, estimates put the size of the low-productivity (mostly "informal") urban work force in Latin America at 30 to 40 percent of the total, depending on how "informal" is defined. This figure is similar to estimates of the proportion of "informal," low productivity workers in the United States and other developed countries for relevant historical periods (1900-1930) (Tokman, 1982). But there is a difference between the employment structures of low productivity activities in the two cases (Table 5). In the United States in the early 1900s, the

TABLE 5

COMPARISON OF THE STRUCTURE OF URBAN EMPLOYMENT IN LATIN AMERICA (1950-1980) AND THE UNITED STATES (1900-1930)

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

a. Percentage of the total labor force. Informal workers are defined as the sum of the self-employed, unremunerated family workers, and domestic servants.

b. Percentage of the total labor force.

c. Percentage of the manufacturing labor force.

Source: Portes and Benson (1984), taken from PREALC (1982); Tokman (1982: Table 4); Lebergott (1964: Tables A3 and A7).

"informal" labor force was concentrated in service activities. In Latin America, by contrast, the informal work force is equally distributed between manufacturing and services. Dualism in Latin American manufacturing is pronounced and seems to be stable over time. In the United States, self-employment in manufacturing was relatively small by 1900 and declined substantially over the next three decades.

Why have the self-employed in manufacturing not been incorporated into more modern segments of industry as growth accelerated in most Latin American countries? As structural transformation of the economy proceeds and industrialization picks up speed, the first segment of the urban labor force that should disappear or decline is self-employment in manufacturing. There are two reasons for this. First, the diffusion of modern technologies (usually imported), which is the engine of industrial development, should increasingly drive tradional, artisanal, and other lower productivity methods out of existence. Second, the absorption of labor into more modern production should affect first those workers with training and occupational skills. Self-employed artisans are generally among the more skilled workers available. The fact that the percentage of self-employed in manufacturing remained constant over 30 years means that the absolute number of such people increased by at least 1.8 million workers (Portes and Benson, 1984). In the face of reasonably rapid rates of industrial growth, a decline in this segment of the work

force would have been predicted. What has occurred, therefore, is a suspension of the process of efficient structural transformation.

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

--chronically overvalued exchange rates;

--high levels of effective protection;

--high taxes, combined with measures of tax relief which encourage the use of capital;

--labor protection laws;

--unions;

--financial market policies which include controlled interest rates and selective credit controls; and

--pervasive government regulations on all kinds of economic activity.

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

The policy environment has been responsible for at least two important distortions in labor markets that have influenced the structure of economic activity. First, wage rigidities attributable to labor laws, other government regulations, union activities, and legislation which provides expensive forms of insurance for contractually hired workers and protects them from dismissals during downturns in economic activity have resulted in the emergence of two modes of labor utilization in both manufacturing and services -- contractual and informal or casual (Portes and Benson, 1984). These measures have made employers reluctant to increase the number of contractually hired workers, since this raises costs and decreases managerial flexibility. As a result, there is a concomitant tendency to make use of the highly elastic labor supply offered by the pool of casual and self-employed workers in manufacturing. This labor supply is accessible through two channels: direct hiring on a casual basis (eventuales) and subcontracting of production or marketing services to small establishments or households. These types of labor utilization make it possible for "modern" manufacturing (and service) establishments to pay "traditional" wages. The popularity of these devices leads to a distortion in the employment statistics, since many of those who are de facto employed by modern industry are recorded as engaged in "informal" activities.

This mode of labor utilization is fundamentally different from the one required for efficient structural transformation. In a less

distorted policy environment, employers, responding to the prevailing competitive pressures and opportunities, reach out to workers and sub-contractors in more positive ways. In such a policy environment, the emphasis is on finding ways to reduce costs and increase productivity, not on how to get around policy-induced cost increases and distortions. Workers are trained to upgrade their skills and reduce turnover, and high-quality sub-contractors are actively recruited and provided with equipment, loans, and training in quality control. These practices reflect continuous pressure to improve the conditions of employment as growth proceeds.

The second important channel through which policy-imposed distortions condition the structure of economic activity is by way of technological diffusion (Nelson, Schultz, and Sleighton, 1971). Distorted domestic factor markets tend to slow down the processes of technological adoption and learning by increasing the cost of modernizing and expanding firms. They also reduce pressure on lagging firms to upgrade their production techniques. It is the workings of the labor and capital markets that provide the squeeze on low-productivity economic activities needed to move efficient structural transformation along. Slow adoption of new technology increases the survival space for lagging, more traditional firms (Winter, 1964). In an environment in which incentives are severely distorted by policies and regulations, the process of growth and structural transformation can become stalled.

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

As we have already pointed out, quite significant intersectoral shifts of employment occurred in Latin America between 1950 and 1980. Such labor reallocation contributes to the growth of productivity when it improves the allocation of resources (Chenery, Robinson, and Syrquin, 1986). A crude measure of labor productivity by sector is output per worker in the sector, relative to the average for the whole economy (Table 6). Differences in the average product of labor reflect the faster growth of total factor productivity in "modern" activities, as well as policy-induced misallocation of labor, such as the large and relatively stable self-employment in manufacturing and surplus labor in agriculture and services.

Reallocation of labor from low-productivity sectors to higher-productivity sectors makes it possible for average productivity in the economy as a whole to grow faster than the average of the sectoral rates. Between 1960 and 1980, such labor shifts accounted for about

28 percent of average growth in output per worker in Latin America, a figure similar to the average for upper middle-income countries (Table 6). When resources are not allocated efficently, the resulting slack in the economy becomes a potential source of growth. Rapid shifts may contribute to the acceleration of growth, but such shifts are made possible by high rates of output growth and investment. As measured by the extent of self-employment in 1980 (Table 5), consider-able slack existed in the economies of Latin America, and especially in Peru, Colombia, and the Southern Cone countries. To make matters worse, the economic crisis since 1980 has undoubtedly increased this slack.

2. Implications for Policy Goals and Programs to Deal with the Informal Sector

The first lesson is that policy and program interventions should not perpetuate structural heterogeneity. Rather, the policy objective should be to foster a more efficient structural transformation by stimulating economic growth and smoothing the way for a more effective adjustment of resources to accomodate the growth process. As we will show in the next section, policies and programs aimed at promotion of small or "informal" manufacturing enterprises, such as cottage industry promotion programs and the like, may help to sustain the suspen-

TABLE 6

RELATIVE PRODUCTIVITY BY SECTOR

	(Total GDP per worker = 100)						Effect of reallocation on productivity growth	
	1960			1980				
	Agric.	Ind.	Serv.	Agric.	Ind.	Serv.	Annual rate	Percent of growth of productivity
Venezuela	17	168	132	36	164	86	0.9	42
Uruguay	93	89	109	69	108	105	0.1	6
Chile	30	163	117	42	141	99	0.6	80
Argentina	100	80	116	68	105	105	0.1	2
Mexico	29	145	220	23	125	163	1.2	32
Costa Rica	51	101	183	57	108	125	0.9	37
Peru	34	167	178	21	237	106	0.7	53
Panama	34	115	190	28	97	147	1.1	36
Brazil	36	225	145	45	128	123	1.3	22
Colombia	63	127	147	63	110	124	0.5	24
Nicaragua	38	123	261	48	179	132	1.0	100
Paraguay	65	101	180	60	110	158	0.3	10
Dominican Rep.	40	182	240	45	170	137	1.4	42
El Salvador	51	106	237	49	127	182	0.5	29
Bolivia	42	133	240	38	141	159	1.2	47
Honduras	53	172	231	47	150	207	0.7	48

105

Means							
Latin America	46	129	172	44	137	126	0.7	28
Lower mid-Y	51	227	217	40	206	154	1.2	40
Upper mid-Y	37	165	158	33	139	121	1.0	26
12 Industrial*	64	113	123	68	115	98	0.2	5

*1950 and 1976.

Sources: Maddison (1980); World Bank (1983b); Syrquin (1987).

sion of structural transformation. For example, programs targeted on particular enterprise size classes can, in spite of good intentions, create higher "marginal tax rates" on firm growth. When enterprises grow, they must forfeit these special subsidies as well as meeting the extra costs involved in conforming with regulatory requirements and becoming more visible to the tax authorities and other official bodies. The end result can be the creation of a "growth trap" at the bottom of the size distribution of enterprise. Such programs in countries such as India (Little, Mazumdar, and Page, forthcoming) and the Philippines (Biggs et al., 1987) had just this result. These countries reaped some short-term employment gains from small enterprise promotional programs, but in turn gave up the much larger long-run growth and employment benefits that would have ensued from greater production efficiency and an ability to compete on world markets.

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

ity employment must be addressed at both the micro- and the macro-economic levels.

Third, as the data indicate, it is generally not so much the overwhelming size of the self-employment or small-scale sector that is the problem.[4] Rather, it is the composition and stability of such employment that is troubling. These characteristics indicate a suspended process of structural transformation. To address this problem, policy and programs must aim at removing distortions that have driven the economy away from efficient growth and transformation. In addition, efforts should be made to promote dynamically efficient industrial growth by way of an industrial organization that stimulates competition, enhances productivity growth, and permits a better distribution of income. As we will outline more specifically in the following section, the aim of liberalization and industrial promotion programs to accomplish this task should be to build up the "progressive" middle of the size distribution of enterprise, which has generally been squeezed out in past industrial growth. Policymakers should aim to promote the participation of progressive small and medium fimrs in domestic and international markets.

Finally, in the presence of rapid urbanization and a policy and regulatory environment which benefits a limited number of workers and firms, an individual's choice of self-employment may be rational and efficient in the short run. In the longer run, however, substantial economic and social gains depend on the achievement od much higher

productivity levels through the creation of more efficient units of production. As these units are created, labor will be drawn into the more highly organized sectors of the economy, where there is better protection of property and contractual rights and higher wages and benefits will be paid.

C. Enterprise Aspects of the Problem

1. Firm Size Distribution and Economic Development

Broadly speaking, the empirical evidence indicates that during the process of economic development the size distribution of industrial enterprises passes through three stages:

1) A phase in which household and cottage-shop manufacturing is predominant (50 to 75 percent of total manufacturing employment);
2) A phase in which small and medium workshops and factories emerge at a comparatively rapid rate and replace cottage-shop manufacturing in many sectors;
3) A phase in which large-scale production becomes predominant, displacing the remaining cottage-shop activties and a large share -- though not the whole -- of workshop and small-scale production.

None of these phases, however, is distinct. In fact, there is considerable overlap in the transition from each stage to the next, and the rate of change is likely to differ among industrial sectors and regions of the country.

The forces which drive the organization of manufacturing activity through these phases and thus ultimately determine, in large part, the firm size structure at any point in time are extremely complex. Three critical factors driving these changes, however, are: (1) rises in per

110

capita income and resultant changes in patterns of domestic demand; (2) the development and and adoption of new technologies; and (3) the influence of government policy on these two variables.

On the demand side, increases in per capita income alter the mix of industrial sector outputs demanded. Over time, there is likely to be a shift toward more sophisticated products, which are most efficiently produced by larger firms (i.e., products for which there are economies of scale in production). This causes the structure of manufacturing activity to shift toward larger firms. On the supply side, changes in technology may also lead to production by larger firms. Adoption of poorer countries of technologies developed in richer countries leads in this direction, since such technologies were usually developed to cope with conditions of expensive labor and cheap capital equipment.

The third main influence on the size distribution of firms is government policy. Policy can have a profound implications for the mix of products that is produced and the production technologies used within industries. For example, policies which distort trade patterns may result in a "premature" shift of resources into industries which require more complex, capital-intensive production arrangments. The size structure of industry in this case becomes more skewed towards large firms as production shifts into products that require capital-intensive techniques and longer production runs. Financial policies can have a similar impact. Controlled interest rates and credit rationing generally discriminate against small firms, working to promote larger firm size in every industry.

Looking at the distribution of industrial employment by firm size for a low-income country, one is likely to see a bimodal distribution, with many, possibly most, workers employed in small enterprises, few employed in medium-size enterprises, and relatively many employed in large enterprises.

It we compare the distribution of industrial sector employment in several Latin American countries with distributions for a number of other countries (Figure --), we see that they are decidedly skewed toward large enterprises, much like the manufacturing sectors of advanced industrial countries (the United States, United Kingdom, West Germany). The difference is that in the advanced industrial countries cottage and small firms have, over time, been incorporated into the modern manufacturing sector. In Latin America, manufacturing remains highly dualistic, with a pronounced distinction between large, capital-intensive continuous-process manufacturing establishments, on the one hand, and small-scale, job-shop establishments using traditional technology, on the other. Changes in industrial structure have been occurring, but the size of the household and cottage sector remains large.

Government policy affects the evolution of the distribution of firm size in the industrial sector in two main ways: by helping to block the entry of new firms to the upper reaches of the size distribution and by creating a "growth trap" which helps to keep small firms with growth potential near the bottom of the distribution. There are significant gains in output and productivity to be made from creating a policy environment which stimulates the participation of small and

medium sized firms around the middle of the size distribution. For these gains to be realized, policy must permit (and preferably facilitate) both the growth of small firms into the middle size range and the creation of new medium-size firms.

2. Economic Advantages of the Dynamic Middle

There are important economic advantages for any developing country in having an industrial structure that contains a sizeable group of progressive small and medium enterprises. It does not follow from this that indiscriminate promotion of small and medium firms should be a policy goal. Rather, we argue that by formulating a policy regime which encourages progressive small and medium enterprises to participate in efficient industrial growth a country creates not only a setting conducive to growth and development but also positive externalities that make the economy more resilient, vital, and equitable. It is our position that the policy should not be simply to establish more small and medium firms. Instead, it should be to build up a sizeable group of progressive small and medium enterprises ("firms with a strategy") that are competitive and innovative at home and abroad. Such firms, we believe, can help to spark higher rates of economic growth and foster a more equitable income distribution.

Competitiveness. For a market economy to function properly, it must be competitive. Competition depends on the presence of many small firms and the absence of overwhelmingly large ones. These conditions are generally met in international markets because most coun-

tries do not export or import enough to influence market price. In domestic markets, however, a combination of various forms of trade protection and policies which limit entry or promote excessive size and industrial concentration can severely reduce competition. Several Latin American countries provide examples of what can happen to industry when it is heavily protected from international competition and when government policies promote only limited competition in domestic markets.

Taiwan and South Korea furnish instructive contrasts to the Latin American situation. In Taiwan, the conditions of competition and proper functioning of markets are better fulfilled than in most other private enterprise economies. The presence of many small and medium firms in the domestic market and only limited protection from foreign competition foster innovativeness and rapidly rising productivity. Firms that do not reduce costs to competitive levels will not survive. New technologies and innovations in one industry or sector are quickly spread to others. Korea, on the other hand, has more large firms and state intervention, and thus also has less domestic competition than Taiwan. But Korea fosters competition in its industrial sector by exposing its firms to international competition and by state policies that reward only those forms which perform. In this fashion, it has made its industrial sector one of the fastest growing in the world. The interesting point made by Taiwan and Korea is that the firm size structure itself is not decisive for competitiveness and productivity growth. Korea has a firm size distribution that is similar to those

of many less dynamic economies, but it follows policies which produce rapid economic growth.

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

Flexibility to adapt to capricious international markets. Industrial growth and participation in international markets requires progressive small and medium firms flexible enough to respond to the changes in prices, tastes, and changes in technology, that occur so frequently. Even in those developed countries which have had success in export markets in recent years, medium and smaller progressive firms have played an important role, along with larger enterprises. For example, one key to German wealth is the medium-size specialist manufacturing firm. Companies of this sort, with a small to medium turnover and work force, account for roughly half of Germany's exports of capital equipment. One of the surprises of the 1970s was the way they mastered the challenge posed by the high Deutschmark, after the breakdown of the fixed exchange rate order. It became clear that dedication to a particular product, continuous technical development, reliable delivery times, after-sales service, and, above all, exact

fulfillment of orders could outweigh quite a handicap on price. In addition, a study (source?) found that smaller German companies were more likely to make use of new inventions than big ones: 70 percent of new ideas were incorporated into the products of small companies within two years; within larger firms, only about one-third of the new ideas were used.

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

What does current evidence suggest with respect to these matters? In recent surveys of narrowly defined industries in India, Colombia, the Philippines, and elsewhere, the notion that small, especially very small, manufacturing enterprises are relatively more efficient users of resources was found to have no general vailidity, from either a technical or a social point of view (Little, Mazumdar, and Page, forthcoming; Cortes, Berry, and Ishaq, 1987). On the other hand, these studies did find that medium-size enterprises are generally

efficient. In many industries, medium-size enterprises come out best in examinations of the relative efficiency of different scales of production. This evidence lends support to the contention that a "missing middle" in the enterprise size structure, holding other things constant, may imply reduced industrial efficiency.

On the subject of relative factor intensity, the studies cited above arrive at a somewhat surprising conculsion. First, in some industries the differences in labor intensity between large and small enterprises is not great. Very small modern factories or workshops may be very capital-intensive. Moreover, the differences in labor intensity between firm size classes within industries that do exist are dwarfed by differences among industries. This implies that, for manufacturing as a whole, small and very small firms are labor-intensive because labor-intensive industries have a relatively high proportion of small enterprises. That is, small enterprises are labor-intensive because they are usually found in labor-intensive industries, not because they are always and everywhere labor-intensive. This conclusion points to the importance of a country's pattern of industrial output for both the existence and factor intensity of small enterprises.

What does all of this ultimately say about small and medium enterprises and employment? In essence, these findings show that indiscriminate promotion of small and enterprise is not the answer to the employment problem in developing countries. This is true for at least two reasons. First, programs and policies that target small-scale enterprises indiscriminately may achieve short-term employment

gains at the expense of longer-run efficiency and even greater potential employment benefits. Second, expanding employment is not the only relevent policy goal. The conditions of employment are equally important. Creating more jobs at low and stagnant or declining real wages may help relieve immediate distress, but it is not development. Employment growth in low-paid cottage industries or service activties is more likely to indicate a lack of development than its presence.

Policies and programs aimed at promoting efficient industrial growth and an industrial structure with a progressive "middle" of small and medium firms would, in our view, substantially allay the output-employment trade-off. First, such firms are likely to be both efficient and relatively labor-intensive. Second, their growth fosters an efficient industrial development process which will yield many high-productivity jobs over the longer run. Trade liberalization, investment incentives, and regional policies that encourage the participation of progressive small firms twist the pattern of industrial output in the direction of comparative advantage and induce technology choices more in line with local resource endowments.

A policy environment which supports entry and expansion of progressive smaller firms would similarly work to enhance the conditions of employment in several ways.

First, the locomotive driving manufacturing growth and structural transformation in developing countries is the process of technological "learning". Unlike the earliest industrializing countries of the 18th and 19th centuries, in which invention sparked industrialization, 20th century industrializers acquire technological competence by importing

foreign technologies, adapting them to local conditions, and learning by doing as production proceeds along the international product cycle. Within countries, industries, firms, and entrepreneurs differ greatly in their ability to acquire necessary technological capability and new technologies. Thus, at any point in time, one would expect to find considerable variation among firms with respect to vintage of technology used. The ability to acquire technological capability is not just a function of the level of human resource development (education and experience), but is also influenced by the investment climate and the policy regime. Further, imperfections in domestic factor markets, either policy-induced or other, tend to slow down the acquisition of technological capability by raising the cost of expanding firms.

In the end, a lagging process of technology acquisition and diffusion means slower industrial growth and either stagnating or deteriorating conditions of employment (constant or falling value added per worker), depending on the rate of labor force growth. It also means that there is less survival pressure on inefficient producers to modernize. As a consequence, the shift in the composition of the work force toward higher productivity activities and enterprises (and away from household and cottage production), an important element of structural transformation, will be retarded.

Second, medium-size and larger progressive firms (and smaller ones in some industries) have the necessary economies of scale in production techniques and export marketing to develop a competitive advantage in various products in world markets. In countries like Taiwan and South Korea, the rapid growth of relatively labor-intensive

exports emanating from these firms pulled labor from less productive activities into higher productivity jobs.

Finally, all these factors should have beneficial implications for the distribution of income. It can be argued that a strategy to remove the barriers to participation of progressive small and medium firms can result in growth with equity.

Entrepreneurship, learning-by-doing, and demonstration effects. Increased participation of small and medium firms will mean that more individuals can develop and utilize their entrepreneurial talents. In countries which now supply trained and skilled workers to other economies through emigration, more of the available talent pool will be retained at home.

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

3. Policy Biases

The failure to realize these advantages in many countries is partly attributable to unconstructive policy biases. These operate both to protect large firms from competition from the up-and-coming

progressive small and medium firms and, in some, cases to protect the small, thereby helping to keep them small and unprogressive.

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

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

Some countries, notably India, have matched this kind of protection of large industry with protection of small firms, thus explicitly promoting a dualistic structure and a "missing middle". More commonly, however, policy promotes this outcome without intending to do so. A "small firm growth trap" is created by policies which impose, in effect, very high marginal tax rates on small firm growth. An example of this phenomenon was provided by the recent EEPA report on the Philippines (Biggs et al., 1986). In that country there is a minimum wage law, which most small firms evade, and sales and profits taxes, which they commonly do not pay. If, for example, a small firm pays its

profits tax but its wages are 20 percent below the minimum wage and it evades sales tax, the marginal tax rate on its profits if it grows into a size range in which it must start paying sales tax and comply with minimum wage regulations is 85 per cent! If it cannot expand its profits by more than 85 percent, it will lose money by expanding. This example assumes that the firm pays profits tax on its net income, both before and after expansion. Besides the tax and minimum wage regulations, there are other regulations which small firms can often ignore or "negotiated," but which become more effectively binding as the firm grows larger. When all these factors are taken into account, it becomes clear that the marginal tax on firm expansion can easily exceed 100 percent, providing a powerful disincentive to firm growth.

The basic principles of economic policy involved here are extremely simple. First, tax rates rates must be set -- and enforced -- at a level which does nor unduly discourage firms from paying their taxes and thus permits them to operate, from the start, in the "formal sector" of the economy. Excessive taxation, unevenly enforced, encourages firms to operate "underground," implicitly creating a high barrier to entering the "legitimate" business world. Second, tax policy must pay explicit attention to the relationship between high marginal tax rates and disincentives to firm expansion. Third, minimum wage laws, if enforced, are highly distortionary. They not only encourage firms to cut down on labor use but also discourage firm growth.

Many small firms are established simply to provide their owners with a livelihood comparable to what might have been earned in wage

employment. What we have termed "progressive" small and medium firms are different, in that the owner/entrepreneur of such a firm typically has the objective of expansion over the long haul and has formulated a more or less coherent strategy for achieving this objective. The progressive entrepreneur places a high priority on technically efficient production, and is engaged in an ongoing search for ways to reduce unit costs and improve product quality. Most fundamentally, the progressive firm aims to anticipate changes in its environment and adapt to them, anticipating and planning for change, rather than waiting for changes to occur, then reacting defensively and possibly being left behind by the ongoing process of changing markets and technologies.

Progressive small and medium firms have already achieved a degree of managerial competence, and are less likely to benefit from government assistance in this area than from policy and program interventions which enable them to overcome obstacles in the external environment. Such obstacles, and opportunities for overcoming them, must be identified on a country-by-country basis. In the Philippines, we identified four distinct categories on participation that could be strengthened:

1) SMEs that produce as subcontractors for the local market;
2) SMEs that produce and sell directly to the local market;
3) SMEs that produce as subcontractors for direct exporters who sell to foreign buyers;
4) SMEs that produce and sell directly to foreign buyers.

Each of these classes of participation was found to be associated with a specific set of obstacles to entry and expansion (Biggs et. al., 1986, p. 41).

4. The Role of Program Intervention

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

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

Second, the government has an important role to play in providing services which the market fails to provide or undersupplies. When not

all the social returns to specific economic activities can be captured by firms or entrepreneurs, suboptimal amounts will be produced from society's point of view. Examples include R&D activities whose benefits can quickly and easily be diffused to competitors and employee training programs involving skills used by a number of firms. In such cases, the government can either subsidize firms to provide the needed services in larger quantities or provide them directly through government programs. Access to information on export markets is a related example. The high cost of learning about such markets may well deter firms from initiating exports, but once the fixed cost is incurred the added cost of diffusing the information to large numbers of firms is negligible. This is a case for program intervention.

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

III. THE POLITICAL ECONOMY OF POLICY CHANGE

A. Sources of Resistance to Policy Reform

Altering existing patterns of industrial development often requires the introduction of new policies to provide incentives and institutions intended to shape the behavior of investors, firms, and wage earners. Policy reform is therefore a fundamental aspect of generating a more dynamic and flexible industrial structure. In many cases, what is required amounts to a "development transition," consisting of "a new policy package, a revamp of basic incentive schemes, and often a trade-off between favored and less favored sectors..." (Cheng, 1986: 3). In recent years, AID, the World Bank, the IMF, and other agencies have redoubled longstanding efforts to use policy dialogue, conditionality, and structural adjustment lending to persuade policy makers in developing countries to adopt important macroeconomic and sectoral policies (see Cohen, Grindle, and Walker, 1985). A strong emphasis on policy dialogue has characterized the activities of AID since the early 1980s (see AID, 1982).

Despite donor efforts, achieving significant change in national development strategies is no easy task. Such reforms impinge on important economic and bureaucratic interests, change the distribution of resources in society, and alter access to the benefits of public policy. Thus, policymakers who decide the direction and scope of public activities in developing countries weigh the often urgent and

well-articulated economic advice they receive from international agencies and their own technical corps against pressing concerns about political stability and bureaucratic compliance. In many cases of policy change meant to alter existing patterns of industrial development, aid donors have discovered that the political impediments to reform often weigh more heavily with decision makers than the economic benefits accruing to the adoption of significant policy reforms. In the 1980s, industrial development has become a focal point of conflict among divergent interests and altering existing policies has proven difficult at best.

Impediments to the introduction of new industrial policy packages were not always so difficult to overcome. In many countries in the 1930s and 1940s, and in a large number of others in the 1950s and 1960s, planners and policy makers assumed major roles in defining development goals, setting the agenda for industrialization, providing a set of incentives for domestic and foreign investors, and creating the physical and financial infrastructure considered appropriate for rapid development. Often, these efforts to chart the course for industrialization met with considerable response, and growth rates in the manufacturing sector were strong for a decade or more (see Hirschman, 1968; 1986).

It is now these policies -- set in motion early in the industrialization process and instrumental in stimulating initial growth in manufacturing -- that are the target of reformist initiatives. Over the longer term, these policies often encouraged inefficient industries, discouraged savings and investment, and led to stifling bur-

eaucratic controls. In recent years, a consensus has emerged among many development specialists that exchange rates, interest rates, trade structures, wage policies, and private sector/public sector relationships introduced in the past to encourage industrialization now need to be adjusted if rapid economic growth is to resume. Advocates of reform are calling on governments to take the same leadership role in introducing policy reforms that they took 20, 30, 40, or 50 years ago. Such leadership is required to remove biases introduced in the past and to diminish the regulatory role of the public sector. Yet governments appear to be far less able to assume this role now than in the past, despite often greatly improved information, analysis, and advice.

In initial attempts to stimulate industrialization, capital scarcity, institutional underdevelopment, and information gaps loomed large as problems to be overcome. Remedies for such problems, however, could be provided directly through foreign assistance in loans and investments, institution building, and technical advice. Today, constraints on altering existing patterns of industrial development are less susceptible to direct foreign assistance because they are usually defined by the opposition of key economic groups in a society, the need of government to accomodate interests whose support is essential to the maintenance of political stability, and the resistance of bureaucracies that have become accustomed to extensive regulatory powers. Moreover, many influential people in developing countries hold firm ideas about the importance of state-led development and find calls for

liberalization and deregulation much less attractive than the earlier emphasis on state-building (Lancaster, 1986: 10; Nelson, 1984: 788).

Many recent studies have explored how political and bureaucratic constraints emerge over time. For example, Robert Bates has explained why many African governments have selected and pursued policies that "have harmful consequences for the societies they govern" (Bates, 1981: 3).

> By intervening in markets for capital and foreign exchange, and by influencing the structure of markets for manufactured items, the governments of Africa have sought to use government power to promote urban industrial development...These policies create economic environments which generate rents. The rents are both economically valuable and politically useful, and from them are forged bonds of self-interest that tie African governments to their miniscule industrial base. Thus policy choices, made to serve a new vision of the public good, have created a network of self-interest which has proved more enduring than the faith which that vision initially inspired (Bates, 1986: 105).

In an analysis of development policies and agricultural modernization in Latin America, Merilee Grindle presents a similar argument about the legacy of the activist role assumed by the government.

> Effectively, the state subsidized the adoption of capitalist forms of production for a small sector of the population while reducing the availability of capital, technology, and infrastructure to the remainder. In the process, it contributed decisively to the emergence of politically and economically powerful interests that became central to subsequent policy making (Grindle, 1986: 78).

And in India,

> The state elite that inherited the power at the time of Independence enjoyed enormous prestige and a sufficiently unified sense of ideological purpose about the desirability of using state intervention to promote national economic development; it redirected and restructured the economy and in the process exerted great pressure on the proprietary classes...[But] as the aura of special le-

> gitimacy of leaders...waned in the wheeling-dealing of day-to-day post-Independence politics...they could get away with fewer and fewer of the autonomous policy directives...(Bardhan, 1985: 38).

These examples suggest the extent to which governments, once relatively powerful in introducing and pursuing major policy initiatives, become less capable of spearheading reform at later points. Development policies often increase the political and economic significance of particular interests, which in turn act to perpetuate their favored positions as targets of development policy making. Equally significant is the creation of extensive bureaucratic agencies to promote development. With time, most develop clienteles, regulatory power, and patronage-dispensing claims that they loathe to see diminished through reform. In most cases, then, the cards are stacked against successful inroduction of new policies whose intent is to undo the consequences of prior policies.

B. Conditions for Reform

Despite the difficulty of significantly altering industrial policy when economic and bureaucratic beneficiaries of existing strategies have acquired power to resist change, reforms are sometimes introduced and pursued in developing countries. Although each case of policy reform is unique and country-specific explanations are important for illuminating the specific conditions surrounding particular reform efforts, there are conditions that appear to facilitate the introduc-

tion of significant policy changes and are characterized by distinct ways of managing political and bureaucratic constraints. Three of these merit brief mention here: regime change, authoritarian control, and political "engineering."

Regime change -- through a military coup, revolution, or negotiated regime transition -- is a powerful facilitator of policy change. In a regime change, new "rules of the game" for political decision making and the representation of interests are introduced. New coalitions of interests acquire power and may be able to diminish the influence of entrenched economic groups. New leaders are often accorded legitimacy or forbearance to introduce significant departures from previous policies because leaders of the old regime have lost support and credibility. Space for reform is created because regime changes occur in a context of political and economic crisis and preexisting policies (and the governments that pursued them) are held responsible for creating such crises (see Nelson, 1984). Moreovever, when the new regime is dominated by the military, considerable potential for repressing opposition can be called upon. Bureaucratic opposition to change is often overcome through important personnel changes and through the greater centralization of authority that frequently accompanies regime changes.

Some of the most notable instances of policy reform in developing countries have been outcomes of regime changes. Examples include the military coup in Korea in 1961, which initiated rapid export-oriented industrialization (Cole and Lyman, 1971; Cheng, 1986); a military coup in Brazil in 1974, which increased the economy's international compet-

itiveness; the imposition of highly repressive military regimes in Argentina, Chile, and Uruguay in the 1970s, which undertook major experiments in trade liberalization; and the coup in Nigeria in 1983, which made it possible to introduce controls on government spending and resume sensitive negotiations with the IMF. A final, ongoing example is the Philippines, where a revolution culminating in 1985 brought a number of policy reform proposals to the fore.

Given the coincidence of policy and regime change, advocates of reform frequently welcome these opportunities for introducing new initiatives. In the early months of new regimes, technical advisors and international lending or donor agencies often have considerable scope for influencing decision makers who are searching for solutions to severe economic problems. Despite the opportunities for reform that it introduces, however, regime change is not a predictable event on which to pin hopes for policy change. Many countries for which policy reforms are widely advocated are not highly susceptible to regime changes. Mexico, Venezuela, Kenya, and Egypt may be cases in point. Considerable experience in politically unstable countries indicates that regime change does not always result in the imposition of effective government or better policies (see DeCalo, 1976). Moreover, these significant political events can be accompanied by repression of political opposition and abuse of human and civil rights. For these and other reasons, waiting for regimes to change in order to introduce policy reforms is not an efficient strategy for bringing about changes in important policies for industrial development.

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

Empirical support for the frequently cited link between authoritarianism and radical departures in public policy is mixed. There are positive examples from Latin America, India, Korea, Indonesia, and Guinea, but many African regimes have been described as weak authoritarian systems, incapable of exerting effective power over society or economy (see Callaghy, 1986; Migdal, 1987; Jackson, 1986; Lancaster, 1986; Haggard, 1985). Stronger authoritarian governments, such as those in Latin America, are prone to crises of legitimacy and susceptible to revolution and other pressures for regime transition (see O'Donnell, 1979). These regimes rely on closed decision making and repression of opposition, both of which inhibit the capacity to ac-

quire information and feedback on the impact of their policies on the economy or society. Thus, even when such governments appear efficient in introducing change, their success may be short-lived because of longer-term problems of legitimacy and sustainability. Recent experiences in Argentina, the Philippines, Korea, Iran, Nicaragua, and India indicate the political fragility of apparently strong authoritarian regimes.

- Political "Engineering". This is a broad term referring to situations in which a regime does not change, unjust coercion is not used, yet significant policy change is introduced. Such situations are characterized by the active leadership of policy makers, politicians, and reform advocates in creating a coalition of support for policy change and managing opposition to reform. With such efforts, policymakers and reform advocates attempt to lessen societal and bureaucratic resistance. Characteristically, military, urban industrial and middle class groups, public officials, organized workers, and rural elites are those whose support is courted or whose opposition needs to be managed. In many cases, political leadership has been effective in selecting strategies and tactics that mitigate conflict (see, for example, Ascher, 1984). In Taiwan, for example, political engineering through bargaining and persuasion lay behind a shift to export-oriented industrialization from 1958 to 1961 (see Cheng, 1986: 22).

Political engineering may not be a feasible way of introducing policy reform in all countries, but it is a more manipulable -- and attractive -- strategy than waiting for, or actively seeking, regime changes or imposing authoritarian rule. In their efforts to bring

about change, reform advocates use bargaining, negotiation, and sweeteners to soften the impact of new policies on beneficiaries of the status quo (see Nelson, 1984). In dealing with bureaucratic resistance, the use of strategies to alter existing incentive structures is important. For political engineering to be effective, however, knowledge about how decisions are made and implemented in developing countries is essential. The policy process reveals much about how entrenched political and bureaucratic interests wield power over policy choices and how they express their opposition to reform.

C. The Politics of Policy Making and Implementation

Decision making in developing countries tends to be centered in the political executive. Generally, high-level administrators and political leaders dominate the policymaking process and are the targets of the activities of those who want to influence decisions. Much decision making occurs in the halls of bureaucratic entities, planning ministries, the executive mansion, or political party headquarters. This relatively closed decision making process and elite-centered politics leaves wide scope for pressures to be exerted through informal and non-public channels. Political "understandings" with the military about which changes in development policies or budgetary allocations will be tolerated, unspoken recognition of the disruptive capacities of organized groups or economic interests, the implicit power of foreign interests, and private "deals" struck in informal encounters with political leaders often loom large in explaining the political ration-

ale for policy choices. In contrast to the active and influential nature of informal pressures, large-scale organized interest group activity is often elusive in developing countries. Large portions of the population -- peasants and low-skilled workers, for instance -- are generally not organized for sustained political activity and many authoritarian regimes discourage formal interest group or party activity. In some cases, elite interest groups may be well organized and vociferous but wield their real political influence behind the scenes in informal interactions with political leaders.

In developing countries, policymakers often must be extremely sensitive to the popularity and acceptability of the decisions they make because of a lack of basic consensus about the legitimacy of the regime in power or the appropriate nature of governmental authority (see Migdal, 1987). As a consequence, many policy decisions are reached because of their symbolic importance for maintaining the regime in power -- nationalist gestures and national security measures are good examples -- while other policies are adopted because they enhance the capacity of the government to provide tangible benefits to important groups and interests. Similarly, many policies are not adopted because they threaten major confrontations or the overthrow of a fragile regime, or because they imply time horizons that are unacceptable to politicians primarily concerned about the shorter-term goal of maintaining power. Thus, policy making often "becomes a balancing act rather than a search for optima; a process of conflict resolution in which social tranquility and the maintenance of power is a

basic concern rather than the maximization of the rate of growth or some such" (Killick, 1976: 176).

Because policymaking tends to be a closed, executive-centered activity, large portions of the population are excluded from influencing the making of laws, decrees, and policies that often have direct impact on their lives. In contrast, during policy implementation, they may have much greater capacity to reach the bureaucrats charged with pursuing the policies and bring pressure to bear on these officials. Bending the rules, seeking exceptions to generalized prescriptions, proferring bribes for special consideration, working out a deal, having a friend in city hall -- these are immensely important aspects of political participation in developing countries and often become more important the more closed the policy making process is. Governments often acquiesce to this informal and unprogrammed allocation of public resources for good reasons. Such participation, although it results in considerable "slippage" between the stated policy and what actually happens, may help hold a tenuous regime together. According to Migdal, "[t]he state has become...the grand arena of accomodation" in many countries, whose "local and regional strongmen, politicians, and implementors accomodate one another in a web of political, economic, and social exchanges" and where "[t]he local stability that strongmen can guarantee...is critical to the overall stability of the regime" (Migdal, 1987: 427).

These broad characteristics of the policy process in many developing countries -- closed decisionmaking processes, the importance of informal influences, sensitivity to regime vulnerability, and slippage

in policy implementation -- affect the capacity to introduce and sustain policy reforms. In addition, the particular conditions that generate impetus for reform help determine the political and bureaucratic concerns that decision makers are likely to have and affect the process of decision makring. Of particular importance is whether policymakers perceive that a crisis exists that can only be addressed through policy change. Perceptions of crisis or "politics-as-usual" affect how issues get on the policy agenda, who the decisionmakers are likely to be, and the criteria they will use to make decisions.

Many of the policy changes advocated for altering the structure of industrial production in developing countries are crisis-induced reforms in which considerable pressure develops from international agencies, other governments, technocratic elites, or domestic pressure groups to "do something" about a problem if dire economic and social consequences are to be avoided or reversed. As a result, decisionmaking elites tend to believe that the stakes are very high and that the "wrong" decision could bring significantly adverse political and economic consequences. Crisis-induced reforms tend to emphasize major changes from preexisting policies because prior policies are considered to be a cause of the crisis and must be rejected if the crisis is to be overcome. At the same time, decision makers are often aware that such major changes could provoke considerable opposition, particularly from those who are benefiting from the status quo. Because of the perception of high economic and social risk, crisis-induced reforms tend to receive ongoing high-level attention, regardless of the preferences of those who hold decisionmaking authority within the

government. Since decisions are generally made by a relatively small inner group with little outside participation, policy makers will tend to be primarily concerned about maintaining the regime they serve and to worry about the impact new policies will have on politically significant groups in the society.

In contrast, when a policy issue is not surrounded by a perception of crisis, policy makers are seldom convinced that dire consequences will result if the reform is not immediately pursued. Change is conceived as incremental, with considerable scope for trial and error or scaling up if initial efforts provide positive results. More time is available for studying the implications of change and there is greater potential for the reform to become sidetracked or pushed down the policy agenda by more pressing issues. More bureaucratic maneuvering and concern with possible bureaucratic sabotage or resistance are characteristic of reforms undertaken under politics-as-usual conditions. From a more positive perspective, policy makers are able to determine the timing of the initiative and the extent to which it is actively pursued; they can encourage the pursuit of reform when the moment appears to be propitious for it and put it on the back burner when conditions seem to be adverse to its success. Reform advocates have more leeway for thinking strategically about building supportive coalitions and manipulating opposition groups into neutrality or quiescence. In general, then, non-crisis conditions give policymakers greater control over the timing and content of reform but may also rob them of the pressured political environment that can act as a stimulus to change. With non-crisis problems, policymakers tend to be less

concerned with regime vulnerability and more focused on issues of bureaucratic performance, compliance, and responsiveness.

For most reform initiatives, whether undertaken in a context of crisis or politics-as-usual, conflict over policy content is inevitable. The lineups of those engaged in these conflicts will vary, of course, because policy changes affect distinct interests differently (a devaluation generally favors exporters and harms importers, for example), the capacity of different interests to express their discontent or support varies (industrialists tend to have much greater access to the policy making process than do peasants, for example), and sequences in applying reform differ in how groups are able to adjust to change. Similarly, the arenas in which conflict is expressed will vary, depending in part on the way policies are formulated and implemented and the access that opponents of reform have to the decision making process and where they can most effectively exert pressure to alter policies they oppose. For policies that affect the structure of industrial development -- exchange rate, trade, financial systems, and investment incentive policies, for example -- critical arenas for conflict can be anticipated on the basis of such criteria.

Critical arenas for conflict over exchange rate policy reform are likely to be centered within a small group of officials who determine, usually in secret, what the policy is to be, and in the reaction of sectors of the population most affected by the impact of devaluation. Thus, altering the exchange rate may be an extremely difficult decision to agree to and will involve considerable discussion, debate, and study among high-level officials and their technical advisers. How-

ever, once policy makers have reached a consensus broad enough to allow them to make the decision, and the central bank has adopted the change, the major task of reform is accomplished, assuming societal reaction does not topple the regime that introduced the change. Bureaucratic opposition will not be a significant issue in this type of reform because, once agreed to, it is essentially self-implementing. Because such a decision is made by a small group of high-level officials, the reaction of those harmed by it will occur after the decision is made and may threaten the sustainability of the regime in power. Thus, decisionmakers contemplating exchange rate reforms are likely to be concerned principally about issues related to regime maintenance and these concerns will be criteria for assessing the questions of whether, when, and how such a policy change is made.

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

isting trade regulations often have developed extensive discretionary power to issue licenses, grant exemptions, apply rules, set rates, and expedite or delay the movement of exports and imports and may be amassing considerable bureaucratic rents from their control of trade policy implementation. In such cases, both individual officials and entire agencies may well resist conforming to new trade structures, particularly those that liberalize and deregulate trade. Policy reform advocates should therefore anticipate an ongoing set of tasks to monitor bureaucratic performance and ensure that extensive slippage does not occur between a decision to make a change and the accomplishment of the intent of the reform. Thus, the political and bureaucratic constraints in trade policy may well be most severe after the decision has been reached to introduce reform. At this point, administrative structures, bureaucratic compliance, and informal arrangements with societal interests have considerable capacity to stymie the reform initiative.

Financial and fiscal reforms -- interest rates, credit controls, the level and structure of taxation -- have important impacts on industrial growth and how much critically affect broad sectors of the population. To the extent that those who benefit from existing policies are able to mobilize to oppose change, they will probably do so publicly and also in more formal efforts to influence decision makers. Conflict over change is likely to be significant at the time such decisions are made and to focus on the high-level decision makers. Bureaucratic opposition to changes that affect discretionary power to allocate credit or to apply tax regulations may also be strong. As in

the case of trade policy reform, officials and agencies may well resist efforts to diminish their capacity to accumulate bureaucratic rents. Reform advocates must therefore be prepared to work to build consensus among decision-making elites that the reforms are essential for economic development and feasible within a particular political and administrative context and to continue to oversee a process of implementation in which considerable resistance and slippage is likely.

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

Political and bureaucratic opposition to reform initiatives will of course differ from country to country, depending upon the degree and type of opposition to government policies that are permitted, the extent to which interests are effectively organized, the bargains struck among conflicting interests, the distributional impact of changes, and the capacity of political leaders to engineer outcomes that both permit significant reforms and contain conflict at levels that do not threaten the viability of the reform or the stability of the regime. It should be clear, however, that the conflictful nature of industrial policy reform means that "[p]ersuasion of government officials will not be sufficient to ensure the adoption and sustainability of reforms. Relationships of political power and influence among affected groups must also be considered if reforms are to be effective and maintained" (Lancaster, 1986: 21).

IV. CONCLUSION

Having read this far, some may come to the conclusion that we have not yet addressed the subject of this seminar -- the informal sector and, implicitly, government policy toward it, or how to develop it. This deemphasis of these issues is deliberate. We wrote what we did out of a belief that the phenomena which some development analysts and practitioners have lumped together and characterized as the informal sector are really certain characteristics of underdevelopment, which have been exacerbated in many countries by ill-advised govern-

ment policies. We preferred, therefore, to address directly what we see as the main issues.

Urban dualism, we have noted, has labor market and enterprise aspects. In less developed countries, most people work for low wages (in small or large enterprises) or are self-employed at low rates of pay, while a few are paid much better wages by larger enterprises or the government. This dualism has long been observed and analyzed by economic theorists (Lewis, 1954; Fei and Ranis, 1964; Jorgenson, 19xx). The cure for dualism is development. As the empirical economists have shown, it disappears as economies grow and generate sufficient demand for unskilled labor (Kuznets, 19xx; Chenery, 19xx). In high-income countries, most people work for large enterprises, where their labor is sufficiently productive for them to be paid a substantial wage or salary. Although many small enterprises exist in rich countries, as in poor countries, most of these firms aim only at providing a livelihood for their proprietor and his/her family; most fail even to do this, going out of existence after a few years at best. A few, however, thrive and grow, providing not only productive employment but a vital element of flexibility, innovation, and competition to the economy.

Given all this, we believe that the first aim of governments in less developed countries should be -- to state a proposition which seems obvious once it is enunciated -- to seek economic development. Development means structural change, but this cannot be forced; it must be achieved in ways that are consistent with efficiency. Small and medium firms have an important role to play, and it is worth en-

suring that the policy environment permits them to play it. Moreover, the policy environment which supports the growth of progressive small and medium enterprises is desirable on other grounds, since it happens to be one which is also conducive to efficient industrial growth and structural transformation.

Unfortunately, many developing countries have already committed themselves to other paths, which led them to significant industrial growth for a time but have now come out at a dead end. For the reasons examined in Section III, above, it will be hard for them to make the necessary change. We do not know whether they can make it, but the effort to do so is worthwhile.

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

(1) In terms of economic development, very small enterprises are, to put it bluntly, only of secondary interest. Few of them

are going to grow; most represent the survival strategies of very poor people. Despite the currently popular rhetoric, efforts to assist them are more in the nature of livelihood assistance than of development policy. More significant development efforts are those which focus on achieving structural change and promoting the participation of progressive small and medium firms in that process.

(2) Policies impinge in major ways on the welfare of those who depend for their livings on the "informal sector". The most important step that could be taken to assist these people is reduce policy discrimination against small and "informal" enterprises. Carried to its limit, this type of policy reform will eliminate dualism itself. The rationale for policy discrimination against the informal sector is weak and based on special class and bureaucratic interests.

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

FOOTNOTES

[1] Some "informal" activities in LDCs exhibit high productivity (e.g., self-employed professionals), but these generally represent a small proportion of the total. Many others provide returns higher than the wages that are paid to unskilled laborers. Some may even show average productivity levels that compare favorably to those of many "formal" economic activities. But all have low productivity relative to the potential levels attainable through economic development. It is above all in the last sense that we use the term "low productivity" in this paper.

[2] Based on Chenery and Syrquin (1974), Chenery, Robinson, and Syrquin (1986), and Syrquin (1987). For each sectoral component in Table 4 (below), the actual value for a given country is compared to the one predicted from the cross-country regressions of the variable as a function of income per capita and country size. The regressions are estimated from samples of up to 103 countries for the period 1950-1983. Average deviations from predicted values for selected indicators (trade and final demand, employment and urbanization, value added) appear in Table 4.

[3] A problem arises, of course, because the economically active nonagricultural population at the beginning of the period (1950) was twice as large as the labor force in industry. Growth at the same percentage rate (4.1 percent) from these different bases meant that absolute increases in modern industrial employment fell considerable below absolute annual increments in the nonagricultural economically active population. For the modern industrial sector to keep pace in absolute terms with the rising economically active population, it would have had to grow at a rate about one-third faster (approximately 6.3 percent).

[4] Some studies indicate the existence of an informal sector which produces as much as 60 percent of value added and employs more than 50 percent of the urban work force (see, for example, De Soto, 1987 on Peru). Measured against the data that we have been able to gather, this seems a bit high.

LIST OF WORKS CITED

Agency for International Development (1982) AID Policy Paper: Approaches to the Policy Dialogue (Washington, D.C.: U.S. Agency for International Development).

Agency for International Development (1985) Blueprint for Development: The Strategic Plan of the Agency for International Development (Washington, D.C.: Agency for International Development).

Ascher, William (1984) Scheming for the Poor: The Politics of Redistribution in Latin America (Cambridge, MA: Harvard University Press).

Ashe, Jeffrey (1985) The Pisces II Experience: Local Efforts in Micro-Enterprise Development: Vol 1. (Washington, D.C.: Agency for International Development).

Bardhan, Pranab (1984) The Political Economy of Development in India (London: Basil Blackwell).

Bates, Robert (1981). Markets and States in Tropical Africa (Berkeley, CA: University of California Press).

Bates, Robert (1986).

Biggs, T., et. al., (1987) "Small Business Policy Direction Study: The Philippines" Ministry of Trade and Industry, the Philippines and USAID (Harvard Institute for International Development, Employment and Enterprise Policy Analysis Project).

British study (1986).

Bromley, Ray (1979) The Urban Informal Sector. Critical Perspectives on Employment and Housing Policies (Oxford: Pergamon Press).

Callaghy, Thomas (1986) The State-Society Struggle: Zaire in Comparative Perspective (New York: Columbia University Press).

Chenery, Hollis and Syrquin, Moises (1975) Patterns of Development 1950-1970 (New York: Oxford University Press).

Chenery, Hollis (1979) Structural Change and Development Policy (\new York: Oxford University Press).

Chenery, Hollis; Robinson, Sherman; and Syrquin, Moshe (1986) Industrialization and Growth: A Comparative Study (New York: Oxford University Press).

Cheng, Tun-jen (1986) "Sequencing and Implementing Development Strategies: Korea and Taiwan," Paper prepared for a conference on "Development Strategies in Latin America and East Asia: A Cross-Regional Comparison" (University of California, San Diego).

Cohen, John M., Merilee S. Grindle, and S. Trip Walker (1985) "Foreign Aid and Conditions Precedent: Political and Bureaucratic Dimensions", World Development, Vol. 13, No. 12. (December), pp. 1211-1230.

Cole, David and Princeton N. Lyman (1971) Korean Development: The Interplay of Politics and Economics (Cambridge, MA: Harvard University Press).

Collier, David, ed. (1979) The New Authoritarianism in Latin America (Princeton, NJ: Princeton University Press).

Cortes, Mariluz; Berry, Albert; and Ishaq, Ashfaq (1987) Success in Small and Medium-Scale Enterprises. The Evidence from Colombia! (New Yrok:
Oxford University Press).

Cowan, L. Gray (1986) "An Overview of Privatization and the AID Experience," Unpublished paper, Bureau for Program and Policy Coordination, (Washington, DC.: Agency for International Development).

DeCalo, Samuel (1976) Coups and Army Rule in Africa: Studies in Military Style (New Haven, CT: Yale University Press).

De Soto, Hernando (1987) "Constraints on People: The Origins of the Underground Economy and Limits to their Growth (mimeo)

ECLA (1965)

Farbman, Michael (ed) (1981) The PISCES Studies: Assisting the Smallest Economic Activities of the Urban Poor (AID).

Fei, John C. H. and Ranis, Gustav (1964) Development of the Labor Surplus Economy (Homewood, Ill.: Richard D. Irwin).

Grindle, Merilee S. (1986) State and Countryside: Development Policy and Agrarian Politics in Latin America (Baltimore, MD: Johns Hopkins University Press).

Haggard, Stephan (1985) "The Politics of Adjustment: Lessons from the IMF's Extended Fund Facility," International Organization, Vol. 39, No. 3. (Summer), pp. 505-534.

Hirschman, Albert O. (1968) "The Political Economy of Import-Substituting Industrialization in Latin America", The Quarterly Journal of Economics, Vol. 82, No. 1 (February), pp. 1-32.

Hirschman, Albert O. (1986) "The Political Economy of Latin American Development: Seven Exercises in Retrospection," Paper prepared for the XIII International Congress of the Latin American Studies Association, Boston, MA October 23 - 25.

International Labour Organisation (1972) Employment, Incomes and Equality. A Strategy for Increasing Productive Employment in Kenya (Geneva).

Jackson, Robert H., and Carl A. Rosberg (1986) "Why Africa's Weak States Persist: The Empirical and the Juridical in Statehood", in Atul Kohli, ed. The State and Development in the Third World (Princeton, NJ: Princeton University Press, pp. 259-282).

Jorgenson (19xx)

Kaufman, Robert (1979) "Industrial Change and Authoritarian Rule in Latin America: A Concrete View of the Bureaucratic-Authoritarian Model," in David Collier, ed., The New Authoritarianism in Latin America (Princeton, NJ: Princeton University Press).

Killick, Tony (1976) "The Possibilities of Development Planning," Oxford Economic Papers, Vol. 28, No. 2 (July), pp. 161-184.

Krueger, A.O. et. al. (1983) Trade and Employment in Developing Countries, NBER.

Kuznets, Simon (1965) Economic Growth and Structure (New York: W. W. Norton).

Kuznets, Simon (1966) Modern Economic Growth (New Haven, CT: Yale University Press).

Lancaster, Carol (1986) "Political Economists and Policy Reformers in Africa: Dialogue of the Deaf? Tower of Babel? On Ships Passing in the Night?" Unpublished paper, Georgetown University.

Lebergott (1964)

Lewis, W. Arthur (1954) "Development with Unlimited Supplies of Labour," Manchester School (May, 1954).

Little, I.M.D.; Mazumdar, Deepak; and Page, John (forthcoming) Small Scale Industrial Enterprise in Developing Countries (Washington, D.C.: The World Bank).

Maddison, A. (1982) "Economic Growth and Structural Change in Advanced Countries" in I. Leveson and J.W. Wheeler (eds.), Western Economies in Transition (Colorado: Westview Press).

Mazumdar, D. (1975) "The Urban Informal Sector," World Bank Staff Working Paper 211, (Washington, D.C.: The World Bank).

Migdal, Joel S. (1987) "Strong States, Weak States: Power and Accommodation" in Myron Weiner and Samuel Huntington, eds., Understanding Political Development (Boston, MA: Little, Brown and Co., pp. 391-434).

Nelson, Joan M. (1984) "The Political Economy of Stabilization: Commitment, Capacity and Public Response" World Development, Vol. 12, No. 10 (October), pp. 983-1006.

Nelson, R., T.P. Schultz and R.L. Slighton (1971) Structural Change in a Developing Country: Colombia's Problems and Prospects (Princeton, NJ: Princeton University Press).

O'Donnell, Guillermo (1973) Modernization and Bureaucratic-Authoritarianism (Berkeley, CA: University of California, Institute of International Studies).

O'Donnell, Guillermo (1979) "Tensions in the Bureaucratic-Authoritarian State and the Question of Democracy" in David Collier, ed., The New Authoritarianism in Latin America (Princeton, NJ: Princeton University Press, pp. 285-318).

Patten, Richard and Snodgrass, Donald (forthcoming) "Monitoring and Evaluating KUPEDES (General Rural Credit) in Indonesia," Harvard Institute for International Development, Development Discussion Paper.

Peattie, Lisa (1980) "Anthropological Perspectives on the Concepts of Dualism, the Informal Sector and Marginality in Developing Urban Economies," International Regional Science Review 5, no. 1, pp. 1-31.

Portes and Benson (1984)

Portes, A., S. Blitzer and J. Curtis (1986) "The Urban Informal Sector in Uruguay: Its Internal Structure, Characteristics and Effects," World Development, Vol. 14, No. 16.

PREALC (1982)

Ramos (1984)

Richardson, H.W. (1984) "The Role of Informal Sector in LDCs," Regional Development Dialogue, Vol. 5, No. 2, (Autumn).

Sanyal, Bishwapriya (1986) "The Urban Informal Sector Revisited" in Bishwapriya Sanyal and Cynthia Ferrin, ed., Urban Informal Sector and Small-Scale Enterprise, Working Paper No. 1, (Washington, D.C.: Inter-American Foundation).

Sanyal, Bishwapriya (n.d.) "The Urban Informal Sector Revisited: Some Notes on the Relevance of the Concept in the 1980s," unpublished M.S., MIT.

Sethuraman, S.V. (1977) "Urban Poverty and the Role of the Informal Sector in Creating Employment" in Equality of Opportunity Within and Among Nations (New York, NY: Preager).

Souza, P.R., V.E. Tokman (1976) "The Informal Urban Sector in Latin America" International Labour Review, 114 (Nov.-Dec.) pp.355-365.

Stokes, Kathryn (1987) "American Development Assistance - Past, Present and Future", unpublished paper, Senior Thesis in Political Science, Swarthmore College, PA.

Syrquin, Moshe (1987) "A Comparative Analysis of Structural Transformation in Latin America" (Bar Ilan University).

Teitel, S. and F.E. Thoumi (1986) "From Import Substitution to Exports: The Manufacturing Exports Experience of Argentina and Brazil" Economic Development and Cultural Change, 34 (April) p. 486.

Tokman, V.E. (1982) "Unequal Development and the Absorption of Labor" CEPAL Review, 17 (August) pp. 121-133.

Winter, S. (1964) "Economic National Selection and the Theory of the Firm" Yale Economic Essays, (Spring).

World Bank (1983)