
LECTURE

Translated by Tim Ennis

**WHY DOES THE INFORMAL
ECONOMY MATTER?***

Hernando de Soto

Ladies and gentlemen, thank you very much for the reception you have given me. What you have asked me to talk about is more or less what is contained in the book "*El Otro Sendero*" ("The Other Path"), and how I and my colleagues at the *Instituto Libertad y Democracia* in Lima, Peru, came to write it.

Essentially, it began with a concern that I have had ever since my student days and my work in Europe. I only came back to live in Peru in 1979, and it had always been a real concern of mine to consider why my country was poor. I was educated abroad in a university in which there were more than 74 nationalities. There I saw that the top graduates might include a Chilean, a Peruvian, a Mexican, a Pakistani or an Indian; and then, in professional life, I saw that there was no difference in terms of

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* Hernando de Soto visited our country at the invitation of Centro de Estudios Públicos and gave this lecture at the Catholic University of Chile on November 17th, 1987, at the launch in Chile of the book *El Otro Sendero*. This lecture has been edited by the CEP.

nationalities there either. I always wondered what this enormous difference between incomes in developing countries and those in developed countries was basically due to, and I did not find any answers in the formal explanations of the causes of wealth and poverty: the explanations I needed were not even between the lines. The explanations that irritated me most were the ethnic or cultural ones, like for example that Peruvians were not made to do business and achieve prosperity like the inhabitants of other Western countries.

When I saw the poverty in Peru with all those people working on the streets, in 1979, I said to myself, “if Peruvians are working very hard what is the cause of the poverty?” I saw people on the pavements, I saw them in the “Young Villages”, as we call the miserable neighborhoods surrounding Lima, building, laboring, showing enterprise and diversifying their client base...Why do they always achieve levels that are so low, despite all this?

I was told this was an unemployed proletariat: ultimately what had failed was private enterprise that had been unable to provide all these people the incomes necessary to live in a dignified way. As this reading of the phenomenon did not convince me, I decided to do something which a French intellectual Jean François Revel recommended to me: he advised me to get closer and observe the patient directly. So that is what I and several colleagues decided to do; we gave up our jobs in business, partially at the beginning and then more and more, and we set up the Democracy and Freedom Institute (*Instituto Libertad y Democracia*), and homed in on the patient.

We assumed that if the informal world was as huge as we thought it was—that world that operates on the borders of legality—then necessarily there would have to be some meeting point with legality. For example, it was not possible, we told ourselves, that 50 percent of the Peruvian population was informal; the activities of informal workers could not be carried on without the authorities knowing about it and tolerating it, either for political reasons or humanitarian or ideological ones, or simply due to corruption. So someone, at some level, must have been in contact with these informal workers and their leaders.

It was after a symposium that we organized, with the first money we received, that we tried to identify where this long interface was. In this symposium we received very useful cooperation from a civil police detective in Peru who had some economics qualifications and who sympathized with our concerns.

Going through the different ministries we typified the main officials who dealt with informal workers, the officials who ultimately authorized them, ignored or persecuted them. And among their number we were able to find the 80 most important informal businessmen, who were living in the western sector of the city. After three long years of interviews and research, we were able to obtain the data with which we wrote *"El Otro Sendero"*.

We discovered that the country's official statistics did not reflect that reality, so what we did was try to measure it. Traditionally, what has been measured with informality is small-scale business. It has been said that informality is a firm of maybe five workers or less; but what we tried to measure was not quantity, but rather what was illegal—what was going on outside the law—and we obtained very different figures from the official ones.

In the first place, we discovered that informal housing in Lima was not 14 percent of the total, as the official figures stated, but 42 percent. Currently, out of every ten buildings constructed in Peru, seven are put up informally and only three within the law. In other words, in one, two or three years' time we are going to reach a point where 50 percent of Peruvian cities are constructed outside the law.

The value of illegal housing in Lima is US\$ 8,400 million, slightly more than the country's external debt. And this US\$ 8.4 billion, representing the efforts of informal workers themselves, compares with the US\$ 169 million the state spends on building programs to help poor people. In other words, of every 50 houses built for poor people, one has been built by the state and 49 by poor people themselves. Moreover, the houses constructed by poor people themselves have been built at one third of the real cost of houses built by the state.

In public transport, we discovered that 87 percent of the buses in Lima were illegal and if we include "minivans", as we call them using the American term, and taxis, it turned out that 95 percent of the public transport was private and informal. The value of buses was US\$ 120 million, and if we add the value of workshops and spare parts, the total industry was worth US\$ 1 billion. The price of a bus ticket in Lima is 10¢, which is equivalent to one fifteenth of the cost of transport anywhere in the United States.

The third interesting statistic is that in the streets of Lima, as in Santiago, there are many street traders. We had 95,000 street traders; the interesting thing is that when we talked with them they said their ambition was to move off the streets to a market or supermarket. This is what some of them have already done, for which reason we began to comb the whole Lima area to find out from street traders where there was a market.

We made our own calculation of the number of markets there were in Lima. We found that there were 331 markets, 57 of which had been set up by the state in colonial times and 264 by street traders; in other words, they have for ever been moving off the streets. In total, 42 percent of Gross National Product was the outcome of informal work.

When we have presented this book in other Latin American countries to which we have been invited, we see a quite similar phenomenon. I was surprised to discover that figures in other countries are even more dramatic than in Peru. 70 percent of Argentina's GNP is informal and 50 percent of man-hours worked in offices are also illegal, which means that one way or another we are all impacted by the same phenomenon.

What these first figures told us was very important: they told us that the Peruvian, free from the tutelage of the state or a boss, organizes or invents his own work. What is happening is clear, so it is no longer a cultural or ethnic problem whereby Latin people are unable to organize to run enterprises.

Another myth also had currency among us: namely that we can set up firms but we do this badly; and not only badly, we do it illegally, something that is becoming another Latin characteristic of the most disagreeable type. Here again we followed Revel's recipe and got closer to the people involved. We managed to locate them, and we came to the conclusion that laws and legal institutions affected the poor entrepreneur differently than those of us who were formal workers, who knew how to play politics, who knew how to exploit administrative contacts within our country. The only way to verify this was by simulating the conditions that they operated under. Our first experience consisted of creating a small clothing workshop. We set up there, with an administrative lawyer, with precise instructions of course, four assistants, a clock and two sewing machines. What we wanted to do was measure the time it took to formally register this production workshop in order to begin to operating inside the law.

So visits from office to office were made, and working six hours a day we took 289 days to complete the formalities to open this clothing workshop; all of which involved ten bribes solicited and two others which we were obliged to pay. In order to ensure there not been any methodological error, as we were businessmen and not academics, we did the same experiment in the city of Tampa, Florida, where many of these bureaucratic formalities can be done by mail, or *ex-post*, or can even be done by a telephone. We also timed this, and it took three-and-half hours. We have just done the same thing in New York, where it took four hours. In short, the North American entrepreneur needs 800 times less time than his Peruvian counterpart to be able to operate legally.

When we looked at the case of housing we asked ourselves why there was so much “squatter occupation” among poor Peruvians; why were all these “Young Villages”, which surround the cities like a belt, the result of illegal appropriations; because the people were simply helping themselves. If there is anything to spare in Peru it is sand, and only 3 or 4 percent of our territory is cultivated. It is a shame that an abundant resource that belongs to the state and is commercially unproductive has to be allocated in this way.

In 1985, there were 275 “squatter occupations” and only three legal land adjudications. So we set up the experiment once again, this time studying the paper work in cases where the transfer of property has been legally carried out. We obtained the following results: if a community leader seeks adjudication of land ownership to set up housing, if he works on it eight hours a day, the formalities will take six years and eleven months. He will have to make 200 bureaucratic steps, sign 207 documents and visit 52 government offices.

Then, when we tried to find out why our friends the street traders took so long in setting up their markets, we realized that from the time they organize themselves on the street to the time when they effectively begin to build their markets, twelve years go by: twelve years of bureaucratic formalities, twelve years wasted by the lack of participatory rights.

So now we had a second interesting answer, because in the case of Peruvians at least, and we imagine this is true of the other Latin American countries too, it is not a question of things being done illegally due to a vocation for illegality, but because the law itself was extremely costly for them. So one of us, who had read the liberal classics, found a solution: get rid of all law and regulations and move to a situation of total liberty so that Peru could start to produce.

The first piece of information we obtained in our long investigation, we obtained thanks to a visit to the area of the “Young Villages” in Lima, where we found two settlements, one opposite the other; one of them wasn’t exactly San Diego, California, but it was very similar. Three-story buildings, palm trees, well tended gardens with Toyotas and Volkswagens outside; through the curtains of the houses one could see that this was middle class. To the right, on the other hand, was a shack made of walls of cardboard or old corrugated iron and old tires. We told our advisors who were retired officials from the Housing Ministry and knew the history of Lima squatter occupations, that clearly here there were clearly two completely distinct groups. Perhaps the first had come down from an Andean village while the second had come from the jungle; ultimately there were

levels of culture here which had to explain the difference. Their reply was no; that almost all of them came from the same Andean village and they all had the same socioeconomic level.

This gave rise to a study which produced the following results: in one of the settlements —the good one— named Mariscal Castilla, the elected leadership had taken the trouble to obtain property deeds, i.e. the legalization of ownership giving inhabitants the security that the state could not dispossess them. For this purpose they had changed the name of the “Young Village” several times according to the name of the President of the Republic himself, and after several years had developed the appropriate contacts. In contrast, the other population across the street, all good and very noble people, did not have a leadership with these same skills, and the result was that ten years later, the value of the homes and buildings in the Mariscal Castilla was forty-one times higher than in the other settlement.

When we repeated the experiment to see whether the example had let us down, it turned out that legal ownership in the space of ten years multiplied the value of the housing by a factor of nine. This showed that, like a foreign mining or oil company, poor people also need property rights and security, and when the state gave this to them and protected them, there was clearly greater investment. Determining property rights is a state task that creates wealth. We also realized something else. By being outside the law, poor people also lacked long-term contracts, and this meant they could not, on the basis of any future sale, obtain a loan to enhance their capital assets. Furthermore, as they generally did not have property deeds, they could not give guarantees to banks either. Therefore, the lack of contracts, deeds and an adequate registry prevented them from obtaining loans or long-term financing, putting them at a huge disadvantage.

They did not have entrepreneurial organizations either. Let us not forget that in the case of the two sewing machines, legalization took 289 days. So, for example, if I am the best button manufacturer in Lima, and I want to sell those buttons through someone who is the best button salesman, I bring together these two resources and clearly we are going to form a good firm. If we are formal or legal, I can propose a deal to the salesman saying to him, “As you are clearly going to be afraid of entering a partnership with me, because once I know what your client base is I might not need you any longer, I propose that we form a limited company in which you have 30 percent of the shares and I have 70 percent, as that is what I believe my machines are worth. Thus we combine my production resources, which are excellent, with your selling talents and market knowledge, which also are excellent, and we set up a great firm”.

As we have not complied with the 289 days of formalities, as most Peruvians and most Bolivians and most Mexicans know, to mention the countries for which I have knowledge of some of the informality data, we cannot close this deal. He knows that one day my wife will say to me, "Why do you continue to associate with Suárez if he does nothing; the only thing he produces is the name?" So clearly I am going to break away from the joint venture little by little. We can only associate with people in whom we have confidence, as this is the only way of bringing together two different tasks that contribute to creating prosperity as a single entity. So, I believe I will associate with my cousins and brothers, my brothers-in-law and my friends, and the other party will do likewise. And one day a North American anthropologist will come along and say to us, "Look, Peruvians like to work in family groups; they are not made to combine resources of production in the most efficient way possible like North Americans".

This is not all: something else is lacking that perhaps will be as strange to you as to us Peruvians. This is extra-contractual law, i.e. something North Americans call "Force Law": the right that makes it possible to compensate third parties for the damage an enterprise between two parties can cause. Or in the language of economists "the right that enables a third party to obtain compensation for the externalities caused by a productive unit".

I will explain this via an example. I mentioned earlier that 95 percent of public transport in Lima was informal and private. However, in 1985, President García proposed that this system be replaced by electric train, i.e. a public and bureaucratic train costing us more about US\$ 1 billion, according to conservative estimates, and US\$ 1.8 billion according to the highest ones. So one wondered why? Well it was very simple, the President had done a survey, and over 85 percent of the population of Lima wanted the quality of public transport to be improved.

It happens that Lima's transport operators are cordially "respected" by the rest of the population. And they are cordially "respected" because anyone who drives beside a bus driver and has an accident with him, has no way to claim compensation for the damage. For every fourteen accidents a Peruvian bus causes, a German bus causes just one. The reason for this is that, to win their bus routes and be able to provide their services, these informal transport operators effectively have had to invade the routes, pay high bribes to police commissioners, and make arrangements with the best lawyers in Lima to win any court litigation.

The transactions undertaken by private firms sometimes give rise to positive externalities and other times to negative ones. When one cannot

compensate negative externalities through the appropriate legal system, an anti-private enterprise attitude is engendered among the population, and with just cause. What happens is that the state, instead of providing this right that is lacking for resolving disputes between private individuals, has recourse to the most primitive instrument: namely, nationalization and statization. Thus, we came to realize that in Peru nationalization has been popular: it was not the heady imagination of a few socialist leaders but the traditional solution when private firms acted against the public interest.

Summarizing all of this, we realized that to set up a market economy not only meant removing the obstacles—huge obstacles—that stood in the way of development, but it was also a question of building bridges where there were precipices. These bridges were good property rights, good contracts, efficient courts, good entrepreneurial organizations, and good extra-contractual rights.

All these legal elements are precisely what most citizens in developing countries do not have.

Now, although I have concentrated on the problems facing informal workers, through the state and due to the regulations that exist in Peru and other Latin American countries, it is clearly not the only sector that suffers from this. Formal workers in Peru are also poor compared with formal workers in more developed countries. According to a small survey of ours, we calculate that the general managers of private Peruvian companies with more than fifty employees spend 50 percent of their time in political dealing; because there is no way of controlling imports, export certificates or tax returns, in countries where 80 percent of freight is managed by the state, where 90 percent of loans are administered by the state and the majority of insurance is provided by the state. Thus, a large amount of time is necessarily lost in making political deals, and this is a really dramatic loss. This makes for uncertainty in absolutely everything.

Well, and what one wonders was all this legal entanglement due to? Perhaps here we will at last identify the cultural element that characterizes Latin Americans—we like to produce bad laws, above all we like to over-regulate ourselves, and this is a problem inherited from Spain and from which we will not easily extricate ourselves. Studying the legal problem, we discovered the following figures: 27,400 rules are sanctioned per year—this means 111 rules every working day.

The second situation we saw was that 99 percent of these rules did not emanate from legislation by Executive Order, without control from the rest of the democratic apparatus. You may ask how this differs from developed countries? Well I will make a comparison. In the United States, for

example, law is produced in three ways. The first is the consensual form of law known as Common Law, i.e. where in thousands of courts throughout the United States every day, they decide how to apply the law to particular cases with the participation of a jury, a prosecutor and a defense lawyer. Little by little this law gets adapted to special circumstances, and it is difficult to imagine that in this way one could create laws ordering legal formalities lasting 289 days. Clearly, in my country there is no common law.

The second way in which they create laws in the United States is through parliament. Here, congressmen compete with each other to see who is the most popular, firstly by being chosen as the most popular candidate in the party by winning a primary, and then in open elections with the candidate who won the primary in the other party. Thus the most popular candidate will be sent to the Congress. Once in the Congress this congressman will want to be reelected and necessarily will have to vote in the way the people desire. For this purpose he maintains active contact with his constituents by carrying out surveys, while they watch him to ensure he is acting in accordance with their wishes. Only if he fulfills the electorate's wishes will he be elected again.

In my country we also have parliamentarians. But they are not elected on the basis of their popularity in a district but according to their position on a single electoral list, so that clearly, the first, second, third or fourth place on the list has a much greater chance of being elected than someone occupying position 120 or 121. The result is that the parliamentarians in my country owe their election to their party more than to the electorate.

The third way in which law is structured in the United States is also through executive power —executive orders, supreme decrees, the workings of ministries— but here such rules are not sanctioned by the will of politicians or public officials: each one is the outcome of a consultation process, for which there are established procedures according to so-called "Office Law". According to these procedures, every public official who has to draw up a regulation or a rule affecting the private economy has to do so in a transparent way explained in a document. With the projected regulation published in this way, along with a cost-benefit study justifying the advantages and disadvantages of the regulation, the project is open to critical comment for the rest of the population, including hearings organized to ensure that each regulation will effectively produce the foreseen result, or at least that its benefits will outweigh its costs.

None of these three systems exists in my country, and the result is that although we have free elections, we choose a President who has 27,040 regulations in his pocket that he can change at will, with no feedback mechanism to enable him to consult public opinion to find out the electorate's preferences. Is not surprising that in a system like this over the years most of the population has been pushed into the informal sector.

It is clear, therefore, that democracy has a lot to do with the market economy because, where there are no mechanisms for the public to control government in each of its acts, there is no way of ensuring that it does indeed fulfill its popular mandate, something that has to be given to it not just once every electoral period, but constantly. The public is always changing its consumption preferences, its forms of production, and this needs to be transmitted to central government. And, in fact, we came to realize why this huge number of people has been able to grow illegally without being brought within law: it is because the government has had no way of knowing what they were doing and what they wanted; not only because there is no mechanism for generating rights, but because when the State introduces a regulation, it is faulty or acts against citizens' economic rights; there is no frank and open possibility of holding the state to account. On top of this, newspapers are also limited; almost 50 percent of publicity in the press is state controlled, as well as 80 percent of credit; Moreover, there is a monopoly of paper.

Thus, democracy—in the long run—is an indispensable element for a prosperous market economy. And by democracy one should not only understand the electoral system: an electoral system is just that, an electoral system. Democracy is also, as the North Americans say, "Government by the people, for the people", and that is achieved not only in elections, but by governing and monitoring leaders to ensure they effectively fulfill what the people want and need at each instant of their societal life.

In short, for I want to conclude here, in American nations there is overwhelming proof that we are entrepreneurs; we have nothing to be ashamed of: we are entrepreneurs operating in the worst conditions. Informal workers also pay taxes. In my country, in particular, 40 to 50 percent of tax revenues come from gasoline tax and, as I said earlier, 95 percent of public transport is informal. So informal workers are paying taxes through this channel. There are also the taxes they pay on formal consumption; there is also inflation tax, because informal workers cannot continually use the banking system, and all uncontrolled monetary issuance by the government is paid by them, as we have an inflation rate of 120 percent. If to this we add the average number of bribes informal workers have to pay to keep

the authorities quiet, it turns out that in my country informal workers pay more taxes than formal workers.

So, firstly I want to state that a broad entrepreneurial base exists, which I expect future studies of our Latin America will confirm. It is not only a matter of encouraging the unemployed but also, and above all, entrepreneurs without opportunities.

Secondly, the reasons why they are poor has to be specified: it has a lot to do with our laws and our legal institutions.

Finally, it is the people themselves who must put these things right: is not a question of each country hiring "Egyptologists" like us who try to discover what is going on in the underworld. This means that only through democracy will rulers know what their people truly want and what they are doing.