

THE INFORMAL ECONOMY IN LATIN AMERICA

Enrique Gherzi

Peruvian writer José María Arguedas once wrote that we Latin Americans are people rooted in ancient cultures: we have unique histories and indelible characteristics. I would say that, among those characteristics, one of the most remarkable is that by which our nations convulse themselves in revolution from time to time.

Contemporary Peru has experienced two such revolutions: one that failed, which is the one attempted by the Shining Path, the Maoist terrorist group that began its insurrection in 1980; and another one that succeeded, which is the revolution of the informal entrepreneurs who work outside the law in every city in the country.

Thus, if we had to conceptually summarize the history of Peru in the last 15 years, I would say that it is the history of those two revolutions: the history of the communist revolution carried out by the Shining Path and the history of the informal revolution carried out by the popular entrepreneurs. The history of a revolution that failed militarily and politically, and the history of a revolution that has surely become one of the most impressive successes of our time.

The Other Path, originally published in Spanish more than 10 years ago, addressed that phenomenon. Written between 1982 and 1986 under the leadership of Hernando de Soto and published in November of 1986, the book represents the most organic effort to analyze Latin American reality from a classical liberal perspective. Its main premise is that, contrary to conventional wisdom, popular capitalism exists in Latin America, and is created by the activities generally categorized as informal. Those informal activities, illegal but not criminal, take place in the absence of legal protection and guarantees because Peru's institutional framework has aimed at maintaining and extending the

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social privileges of the few at the expense of the many. The resulting system is a mercantilist one, which could be characterized as an antidemocratic form of capitalism.

Until the mid-1980s, classical liberalism in Latin America was confined to being a distorted theory applied by the right-wing military dictatorships of the Southern Cone, especially those of Chile, Uruguay, and Argentina. With varying degrees of success, those regimes attempted to apply economic policies inspired by some classical liberal ideas and were, for better or worse, the only arguments that both advocates and detractors of classical liberalism could use to prove its feasibility in Latin America—or to show its inappropriateness. The debate faced a curious paradox: its advocates, genuine partisans of freedom, could unfortunately exhibit only some military dictatorships as presumed liberal governments; its detractors, often advocates of an obstinate collectivism, were able to equate dictatorship with classical liberalism, and fight those two enemies at the same time.

That situation greatly limited classical liberalism's appeal in Latin America, despite its undeniable intellectual vigor.¹ At best, it could aspire to occupy a place among the advanced elites capable of ridding themselves of the deadweight of collectivism. But hardly could it become a widespread message, let alone a mass phenomenon.

However, since the discovery of informality, classical liberalism has begun to break those ties in Latin America, and it has become evident that it offers a different perspective. That new perspective created a great controversy in Peru and the rest of Latin America, and it spread to the United States, Europe, Asia, and Africa with great success. *The Other Path* was without a doubt a seminal book. Indeed, Ronald Reagan said that without it he would not have been able to understand the situation in Latin America.

Up until that moment, socialism had been the predominant ideology in our countries. There existed a kind of prejudice that claimed capitalism was alien to our national identity. The entrepreneur was the enemy and accumulating wealth was a sin. But showing that the poor in our countries freely and spontaneously were generating on the streets and squares of our bustling cities a free-market economy of popular origin, outside and even against the law, *The Other Path* allowed us to see that capitalism was embedded in the Latin American spirit.

In sum, the book showed that the capitalist spirit was as Latin American as it was universal because liberty is inherent to humanity,

¹Many years have elapsed since the time of the old 19th-century liberals, like Juan Bautista Alberdi, and their creative efforts to try to place liberalism in a Latin American context.

not just to one ethnic or cultural group. That fundamental contribution allowed classical liberalism to take the offensive in the world of ideas. Since 1930 that world had been dominated by a sort of indigenous collectivism equally imposed by the left and the right. With no reference to reality, that collectivism was a collection of prejudices that, nonetheless, inspired the ruling politicians from all governments.

A vigorous response has occurred since 1986. Private property, free enterprise, and competition, as inherent rights of the poorest among the poor, have been revindicated. The individualist ethic is shown to have existed in the Latin American past: the law does not limit power, it only reflects it; and the state is a means of oppression of all citizens. I am convinced that the counteroffensive begun by *The Other Path* in the world of ideas quickly moved to the world of politics. Perhaps that was most clearly seen in Peru itself, where Mario Vargas Llosa was at the forefront of this renaissance in 1990.

Someday the intellectual history of this shift should be written. But more than a decade after the restoration of democracy in Latin America, one has to acknowledge that social democracy is increasingly losing ground to classical liberal ideas, especially as a consequence of the public's conviction that liberty and individual responsibility are not characteristics alien to their personalities.

The Informal Economy

We have often read about the underground activities of the informal economy. Conceptually we can offer a simple definition of this phenomenon: underground activities are those that have legal ends but employ illicit means. That is to say, they are activities that do not intrinsically have a criminal content, but must be carried out illicitly, even though they are licit and desirable activities for the country.

Thus, from an economic point of view, the most important characteristic of informal activities is that those directly involved in them as well as society in general benefit more if the law is violated than if it is followed.

To clarify, let me use the example of the itinerant street vendors that help populate the cities of Latin America. The existence of thousands of street vendors is a major feature of cities like Mexico City, Sao Paulo, and Lima, which are among the most populated cities in the world.

The street vendor is, first of all, a merchant. His goals are licit, but he must use illicit means—noncompliance with legal regulations, noncompliance with labor laws, nonpayment of taxes—because he has no other alternative. He cannot incorporate himself in the formal

economy because the latter imposes so heavy a cost on Latin American societies as to make it impossible for people and entrepreneurs with minimal income to enter it. *Informality, then, is a situation whereby people want to work legally, but cannot. The only alternative left is to work in that area of relative illegality created by the legal cracks in Latin American society.*

Although it varies from country to country, the importance of informality is very wide. In the case of Peru, it has been calculated that, in general terms, the equivalent of 38 percent of gross domestic product and 60 percent of man-hours worked take place in the informal sector (De Soto et al. 1986: 13).

That allows us to draw some initial conclusions. First, informality is socially and economically significant because, if 60 percent of man-hours are in the informal sector, the government only controls 4 out of 10 hours worked. Plainly stated, the majority of Peruvians work outside the law.

The second conclusion is that, despite their quantitative significance, informal activities have very low productivity, since, as we have seen, 60 percent of the labor produces only 38 percent of the product. That takes us to some problems that we will have to confront later, especially the lack of a transparent legal system. The "informals," for instance, cannot go to a court of justice to enforce their contracts; they cannot insure themselves against risk; and they cannot acquire secure property rights. As a result, their long-run productivity suffers.

Informal Construction

In the case of Latin America it is significant, at least as illustrated by the Peruvian experience, that the informal sector has a key presence in the construction and housing sector. In fact, urban development in Peru has taken place mostly at the hands of the informal sector. The majority of Lima, a city of 8 million people, approximately half of its geographical area, has been developed completely outside the law, in what Peruvians euphemistically refer to as "young towns," or *pueblos juvenes*, which are nothing more than slums, or marginal urban neighborhoods developed after the invasions of public and private lots by migrants from the countryside during the last 40 years (ibid.: 17).

The development of the informal housing sector has great economic, social, and political importance in the case of Peru. First of all, it is economically significant because the investment people have made in their own informally built homes amounts to \$8 or \$8.5 billion, an

investment that has been made with no government aid of any kind (*ibid.*: 18).

Second, it is socially important because it represents the emergence of a new proprietary class. Traditionally, in Peru—as in the rest of Latin America—the less privileged classes of society had not been property owners. The access to property had been limited to the wealthy or aristocratic classes. Through this process of informal construction, however, the least privileged sectors of Latin America have been able to revindicate for themselves the right to private property and make it a reality in their cities.

Finally, informal construction has had a remarkable political significance because, in the final analysis, only the property owners can fight for their rights. Only when one has a right to own something does one have a sense of responsibility, struggle, and political challenge. Countries without private property are countries where civil society is weak and the citizenry does not confront political power because, in the final analysis, there is very little room left for individual development.

Informal Commerce

Another sector of great importance in the informal economy is the commercial sector. In the past the presence of informal activities in the commercial sector in Peru has been notable, perhaps the most notable of all. Those activities are basically carried out by street vendors—the so-called itinerant merchants that exist in all Latin American cities. They are people of humble origin, probably migrants from the countryside, who, given the financial situation they face, have to become entrepreneurs so that they can earn a living.

Although updated figures are not available, it has been calculated that in 1991 there were approximately 300,000 itinerant vendors in Lima. Many people believe that, as a result of the restructuring programs undertaken by the Fujimori administration, that number has increased significantly. Indeed, half a million public employees were laid off by the Peruvian government and many of them have probably found a refuge in informal commerce.

The social importance of the peddlers stems from their revindication of private enterprise for the least-favored sectors of Latin American society. We have read books and listened to programs that have tried to convince us that capitalism is foreign to Latin America; that those who are entrepreneurs here are part of a foreign front of penetration or a remnant of the colonial aristocracy, but are not true Peruvians, Mexicans, or, even, capitalists because they do not represent true

capitalism. One does not have to write textbooks or quote Adam Smith to see that that is false. It is enough to go out on the streets of any Latin American city and show those who do not want to accept the evidence that the poor in Latin America practice capitalism on the streets, even though nobody has taught it to them; that they do not have to be rich to become entrepreneurs, it is enough to be hardworking; that they do not have to be smart to earn money, they only need to be organized; that they do not have to be geniuses to discover an opportunity, they only need to be audacious.

With decision, honesty, and audacity, the streets of Latin America have become the best business schools available. Thus, those streets vibrating with entrepreneurial activities have become in a way the best argument in defense of free enterprise and Latin American capitalism. In addition, the existence of informal commerce offers the best testimony for those people who have the ideological compulsion to deny the evident: work and responsibility are virtues inherent to the human being.

Informal Industry

The presence of informality is also significant in industry and services. In the case of industry, informal activity is clearly underground.

Sometimes I speak of the underground economy as a synonym of the informal economy. I would rather use the term "informal," which is more technical, because the underground economy gives an impression of concealment that is not accurate in all cases. In fact, informal urbanization, commerce, and public transportation services are absolutely public and visible. There is nothing subterranean about those activities. The terms submerged, hidden, or "own-account" economy are even more misleading and imprecise. Nevertheless, in the case of industry, there are indeed underground activities.

There are two kinds of informal industrialists in Latin America. One is the formal industrialist who informalizes part of his production as a result of the high cost of regulation or taxes. Even though he may conceal part of his production, he belongs to the community of established industrialists. In many cases the high cost of legality in Latin America has forced him to move part of his production to the informal sector. Thus, he has to abandon the formal sector to hide totally or partially in the informal sector. That happens every time inflation rises, which is an indirect way of raising taxes.

The other kind of informal industrialists is made up of artisans and fully informal industrialists, who are employed illegally in the manufacturing sector. There are areas of Peru where that activity is

very pronounced. They include textiles and ready-to-wear clothing, furniture making, and automotive repairs. For instance, in the craft industry, we find people who, in the security and intimacy of their own homes, set up workshops with relatives and friends who, in many instances, do not get paid or get paid indirectly by being taught the trade. In this way, a significant amount of microenterprise activity is generated.

Informal Services

As in the previous cases, the level of informal activity in the service sector is quite high. The most remarkable case is public transportation. In developed countries, public transportation is generally state-run; in developing countries, public transportation is generally private and informal. In Latin America, the emergence of big cities has gone hand in hand with the development of huge systems of informal transportation.

In 1990, 95 percent of urban transportation was in the hands of the small entrepreneurs, each one the owner of his bus or *kombi*. (The term "*kombi* capitalism" has come to describe that kind of entrepreneur.) That same year, the entire state-owned public transportation system went bankrupt. The Peruvian government dissolved the only public enterprise that existed in the public transportation sector by selling to each driver the vehicle he was driving and thus completely informalizing urban transportation. Also in 1990, Ricardo Belmont, then mayor of Lima, liberalized urban transportation when he deregulated routes, rates, and market entry and exit. That forced drivers to use their imagination because, as entrepreneurs, they had to identify the desires of their customers and offer differentiated services.

The liberalization of rates also has resulted in a variety of services and a range of prices. If people want to travel squashed like sardines in a can, they can pay a low price. If, on the other hand, they wish to sit comfortably in an air-conditioned car with a TV—many drivers have installed TVs and VCRs and play videos during the ride—they pay a different price. Even door-to-door nonstop service is offered. That has all been generated informally in the taxicab as well as in the bus sector. It is the absolute reign of informal activity.

Many people believe that the reason President Fujimori has faced little opposition for so many years, even though he implemented the deepest and most dramatic structural adjustment measures in Latin America, is because most of those who were laid off in the public sector found something more advantageous to do in the private sector.

Those who left government jobs as a result of Fujimori's economic adjustments—in all, between 500 and 600 thousand people—immediately began to work in the private sector at much higher wages. For example, during the five years of the government of Alan García, in which inflation was 1 million percent, public employees were paid fixed wages of no more than \$50 per month. On the other hand, they could make up to \$4,000 per month in the private sector as private carriers, without having to invest one penny since the vehicle dealers financed the acquisition of the vehicles.

The Origin of Informality

The origin of informality cannot be found in a cultural shortcoming,² nor in a religious or ethnic problem. It can be found in the inefficiency of the law. Technically speaking, activities are informal because of the cost of legality. Politicians, policymakers, and, especially, lawyers do not understand that the law has a cost like everything else—namely, the amount of time and information necessary to comply with it.

In Peru, as elsewhere in Latin America, the cost of the law is very high; in fact, comparatively higher than in the United States. The difference between developed and developing countries, as Douglass North (1990) has so brilliantly documented, can be found in efficient institutional organization. In other words, the difference can be found in transactions costs or the cost of the law. In a prosperous country, transactions costs are low relative to national income, while the opposite is true in a poor country.

In 1986, we conducted a famous experiment in Peru that enabled us to measure the cost of entry into the market. We created a team that would simulate the establishment of a small clothing workshop, and we set out to strictly comply with all the legal requirements that the legislation imposed, including not paying one penny in bribes to anyone, even if it took longer than necessary. The paperwork delayed us for almost a year and, during that process, we were asked to pay bribes 12 times, of which we had to give in twice, because, had we done otherwise, we would not have been able to continue the experiment.

²Sociology books suggest that we Latin Americans—especially Peruvians—have the defect of being stupid, which explains our inability to progress. Indigenous heritage and Spanish colonialism retarded us to such a degree that, along with corruption, the climate, and spicy food, we have turned into depraved peoples—into something like cultural imbeciles. That reasoning is implicit in conservative eurocentric texts and in delusional Marxist texts. At bottom, that view stems from the rejection of the imagination, strength, and authenticity of Latin Americans.

Later, to get a comparative idea about how long it took us, an American professor conducted the same experiment in Tampa, Florida. What took us a year to accomplish took him two hours in the morning, and he did it through the mail. That was exactly the difference between the cost of the law in Peru and in the United States.

Latin Americans are not demented beings who go around measuring the cost of the law. We only measure the cost of the law when the cost of complying with it is greater than its benefits. People comply with the law when it is convenient. When it is not, they do not comply with it. It is only rational that it be like that.

In Latin America and in Peru, in particular, where we have tangible evidence, the law is costly. It is so costly that it distorts the market and excludes from it the least-favored sectors of the population. Why are there informals, then? Because people, given their small incomes, cannot work otherwise, cannot comply with the law, cannot pay taxes, cannot have access to formally built housing because they cannot afford it. That is the objective reality. It is not a cultural shortcoming; it is not a mental problem; it is not an ethnic heritage; it is legal discrimination.

The origin of that legal discrimination lies in mercantilism. What remains in Latin American countries is a kind of capitalism where private property is not a right but a privilege, private enterprise is also a privilege, and competition does not exist. The state takes it upon itself to create legal obstacles to market competition. With that tendency, which forces us to maintain a kind of institutional Jurassic Park in Latin America, we have been able to preserve the dinosaur of mercantilism from which we suffer: large and incompetent government, on the one hand, and hypocrisy, on the other. The generalization of hypocrisy, which allows us to keep a system of privileges in Latin America, is without a doubt the main cause of our underdevelopment.

Conclusion

That is why I said that modern-day Peru has experienced two revolutions: the revolution of the Shining Path, which was a failure because it did not coincide with the desires of the population; and the revolution of the "informals," who have revindicated for themselves the right to private property, the right to free enterprise, and, above all, *the right to develop their individual capacity and effort*.

In so doing, the least-favored Peruvians and Latin Americans are at the forefront of the construction of an authentic Latin-American market economy and have created the foundation for optimism about future changes. Until recently, there was reason to be very pessimistic

about any major government reforms because they lacked social support. Nowadays, with the emergence of uncontainable informal activities and the development of an entrepreneurial sector of popular origin, large adjustment programs have social support. There are people who demand from the state the right to private property, the right to competition, a sound currency, and less government. In sum, people now demand more space to develop their creativity and exercise their audacity. Those people offer us, maybe in the case of Peru, a political environment where radical and deep reforms can be undertaken.

Many people wonder with admiration why Fujimori has been able to achieve such spectacular success in the economic sphere in half the time, for example, that it took Chile. Peru has taken 5 years to achieve what Chile achieved in 10 or 15 years. Why? I believe that has been so, among other reasons, because there is a base of social legitimacy. People no longer want to hear the myth of the public enterprise; they no longer want to listen to the tale of "social justice." Young people even mock it. Those youngsters of humble origin, with names like Washington Quispe, represent a completely new class that does not believe in the public sector. It is a class that deep inside does not believe in anything, which is a kind of attitude that allows the development of individual responsibility and the confidence that only through one's own efforts can progress and responsibility be created. That confidence in a Latin American individual's own efforts, that conviction that there is nothing in our past that will crush us, enables us to argue that the emergence of the informal economy is perhaps the most socially and economically remarkable event in Latin American history since the arrival of Columbus.

The experience of the informal economy offers us the conviction that Latin America can finally find a solid base for sustained growth and that soon we Latin Americans will all greatly enjoy the benefits of freedom.

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