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PATH

WITH A NEW  
PREFACE BY  
THE AUTHOR

THE ECONOMIC ANSWER TO TERRORISM

HERNANDO  
DE SOTO

Author of  
*The Mystery  
of Capital*

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# The Costs and Importance of the Law

In earlier chapters we examined in detail how informal activities emerged and developed in three specific areas. Thus far, in our account, which is based on empirical research, we have sought to describe the fundamental characteristics of the system of extralegal norms identified by the researchers of the Instituto Libertad y Democracia (ILD) and to trace their historical evolution in order to establish their underlying logic.

All of this has shown that we are living in a costly society in which formals and informals alike waste tremendous resources. We have seen how invasions occur, traffic congestion and accidents increase, and permanent legal instability diverts resources, effort, and ingenuity from productive to political action to avoid legal penalties and win recognition of acquired extralegal rights.

Such problems have generally been thought to have many causes—migration, maldistribution of income, unemployment, even climate. As the ILD pursued its research, however, it became clear that none of these could explain the magnitude and complexity of these problems. Migration may explain the increase in the number of people living in the capital city. Maldistribution of income may explain why such migration occurs. Unemployment may explain why labor is so available. Climate may explain why a certain type of urban development is possible in a given geographical context. None of these, however, can explain why people choose to invade land to build their homes, occupy streets to conduct trade, or appropriate routes to provide transport services. In short,

no one can explain why some people prefer formality and others informality, nor can they determine what the outcome of such a process will be.

This was why we decided to talk to the informals themselves. That is how we found that their main complaint is with the law and why they try to win recognition from the legal system. Accordingly, we set about to examine the legal context in order to determine its influence on individual decisions to operate formally or informally and on the outcome of such choices. The ILD then decided to conduct a number of field studies and analyses to identify and quantify this influence.

In the pages that follow, we present the results of this research. They show, in detail, first the costs of formality—these influence the decision to join or remain in formal activity or outside it—and then the costs of informality—the costs of the lack of protection and facilities that arise when one operates outside of legal institutions. We also show the costs to Peruvian society as a whole. Last, we consider the importance of the law in the entire process and in development in general.

The ILD's research confirmed the role of the law in determining the efficiency of the economic activities it regulates. It is in this sense that we shall refer to "good laws" and "bad laws": a law is "good" if it guarantees and promotes economic efficiency and "bad" if it impedes or disrupts it. The *unnecessary* costs of formality derive fundamentally from a bad law; the costs of informality result from the absence of a good law.

## The Costs of Formality

In an economic activity, there are essentially two moments at which people evaluate their relationship with formal activity: when they enter it and when they decide to remain in it.

To define these two moments in time, the ILD coined two corresponding concepts, "the costs of access" to the activity and "the costs of remaining" in it, so as to examine all the requirements which citizens must meet in order to obtain the right to engage in a specific economic activity legally, and later all the requirements they must meet in order to preserve that legality. We wished to determine whether these costs influence individual choices.

We must make it clear that while our research identified the different costs of obtaining legal access to, and remaining in, an activity, this is not the approach taken by the average person. People who defy the legal system or make use of it make only an overall assessment, generally based on prices, of what it might cost them to comply with legal requirements and

what they can obtain in return for such compliance. Their choice is based not on a precise evaluation but on a vague notion, as if the forest were far more frightening than the individual trees. Our research shows that Peruvians' decisions to conduct their activities informally are in large measure the result of a rational, though less detailed, evaluation of the costs of formality.

## **The Costs of Access**

None of the economic activities investigated by the ILD can be exercised legally unless a whole variety of requirements has first been met. In order to identify these requirements and the costs they entail, the ILD examined four specific areas in which informality is a major social problem: industry, housing, trade, and transport.

### **The costs of access to industry**

The ILD was forced to resort to a simulation to measure the costs of access to industry because, when we began the research that gave rise to this book, we kept hearing conflicting accounts about the difficulty of establishing an industry. The formal business people we interviewed said these procedures were very cumbersome, and the informal business people shuddered at the mere mention of them, but the lawyers maintained that the procedures were very simple and took little time. We decided to find out for ourselves.

In the summer of 1983, a team of ILD researchers set up a small garment factory in an industrial area of the Carretera Central in Ate district on the outskirts of Lima, and decided to comply with all the bureaucratic procedures required to establish it in accordance with the law. They simulated a business with a single proprietor, without incorporating it, since this would provide an extra measurement of the costs of access to the industry itself and would be easier to dismantle.

To do this, they rented the premises of an established factory, installed sewing machines, knitting machines, and other necessary implements, and recruited four university students to undertake the various bureaucratic procedures under the supervision of a lawyer experienced in administrative law. In addition to being very widespread in Peru and thus culturally significant, the activity chosen for the simulation was highly representative. It required approximately 60 percent of the bureaucratic procedures common to all industrial activities and 90 percent of those required of nonincorporated individuals.

The team also decided to handle all the necessary red tape without go-betweens, as a person of humble origin would do, and to pay bribes only when, despite fulfilling all the necessary legal requirements, it was the only way to complete a procedure and continue with the experiment. In the months that the simulation lasted, ILD simulators were asked for a bribe on ten occasions in return for speeding up the procedure. On two of these occasions, they were forced to agree because there was no other way to continue. In the other eight, they were able to avoid having to pay a bribe, although it was far from easy. The simulation was organized as if the ILD researchers were leaving the informal settlement of Villa El Salvador, to the south of Lima, every day to visit the different administrative centers where the procedures were carried out. They went from office to office, took detailed notes, timed the various procedures, and collected the multitude of required documents.

The results showed that a person of modest means must spend 289 days on bureaucratic procedures to fulfill the eleven requirements for setting up a small industry. Graph 1 shows the various procedures, the order in which they had to be complied with, the time they took, and the places where they were carried out.

After the simulation, the ILD calculated the cost of complying with all these procedures. According to these calculations, the cost per procedure was equivalent to \$194.40. The almost ten-month wait to begin business would result in a loss of net profits equivalent to \$1,036.60. The total cost of an individual's access to small formal industry is thus \$1,231—thirty-two times the monthly minimum living wage.

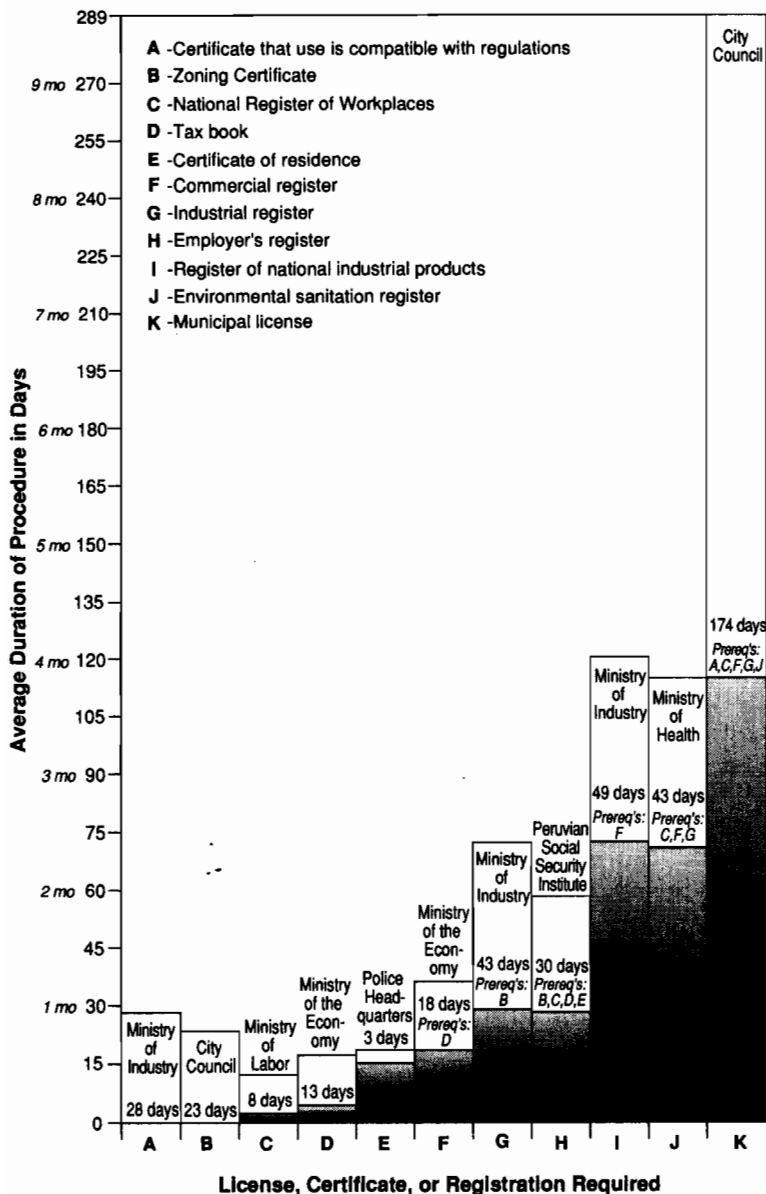
In addition to showing how severely restricted access to industry is, particularly for lower-income people, these initial results confirmed that it was absurd to claim that the law creates no problems. It also demonstrated the utter pointlessness of the entire exercise: despite the 289 days and 11 permits needed, at no point did the authorities realize they were dealing with a simulation.

## The costs of access to housing

The next step was to examine the problem of access to housing.

It was not feasible to use a simulation because it would have been necessary to set up an association or cooperative and commit several hundred people to the experiment for a long period of time. It was possible, however, to use two indirect sources. By examining laws, we could determine the characteristics of the various procedures; and by studying

Graph 1. Procedures to Set Up a Formal Industry



actual administrative cases, we could determine their average duration. This study covered the *only* three cases which, between 1981 when the Municipalities Act—Legislative Decree 51—was promulgated and the date of the ILD's research, had been settled by the authorities. It should be pointed out that, in that same period, several hundred invasions took place.

We learned the following: if a group of humble families decide to acquire urban land for housing legally, they must request adjudication of a piece of state wasteland, present their plans for urbanizing the land, and receive a building permit and certification that the buildings conform to the approved plans, a process that takes an average of 83 months (6 years and 11 months) to complete if they are to comply with all the established requirements (see graph 2).

Of all the tremendous costs of access to formality that we shall describe in this section, this is the most disproportionate. It is therefore useful to examine briefly each of the main stages in this process.

### *Adjudication of state land*

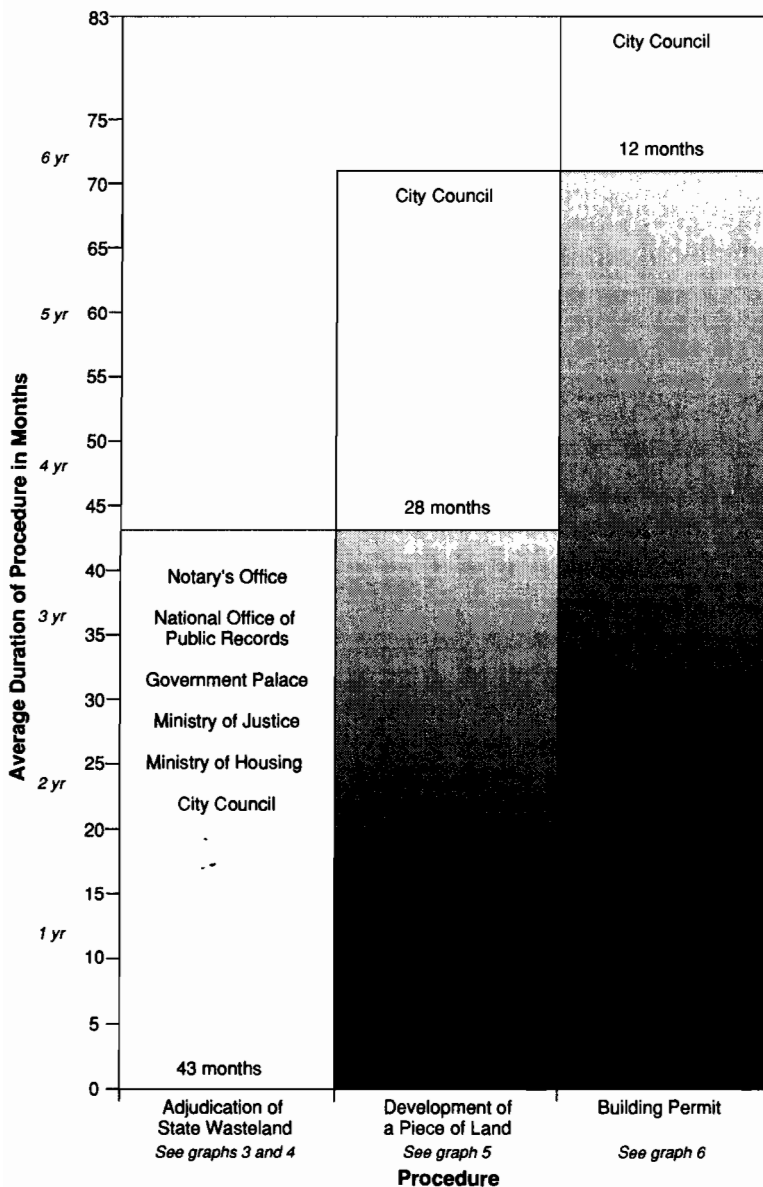
If the parties concerned cannot afford to buy an urbanized lot and have decided to acquire legal ownership of a home, their only course is to request the adjudication of state land.

As can be seen from graph 3 (page 138), this procedure takes 43 months (3 years and 7 months) and involves up to six different state departments, including the president of the Republic. In view of the length of the procedure, the ILD decided to find out what administrative steps were involved and whether the delay was due to the torpor of the bureaucracy or to the need for strict compliance with the regulations. Graph 4 (pages 140–41) shows that the 43 months that it takes for an adjudication are the result of 207 bureaucratic steps involving 48 different government offices. Each step takes about one working week.

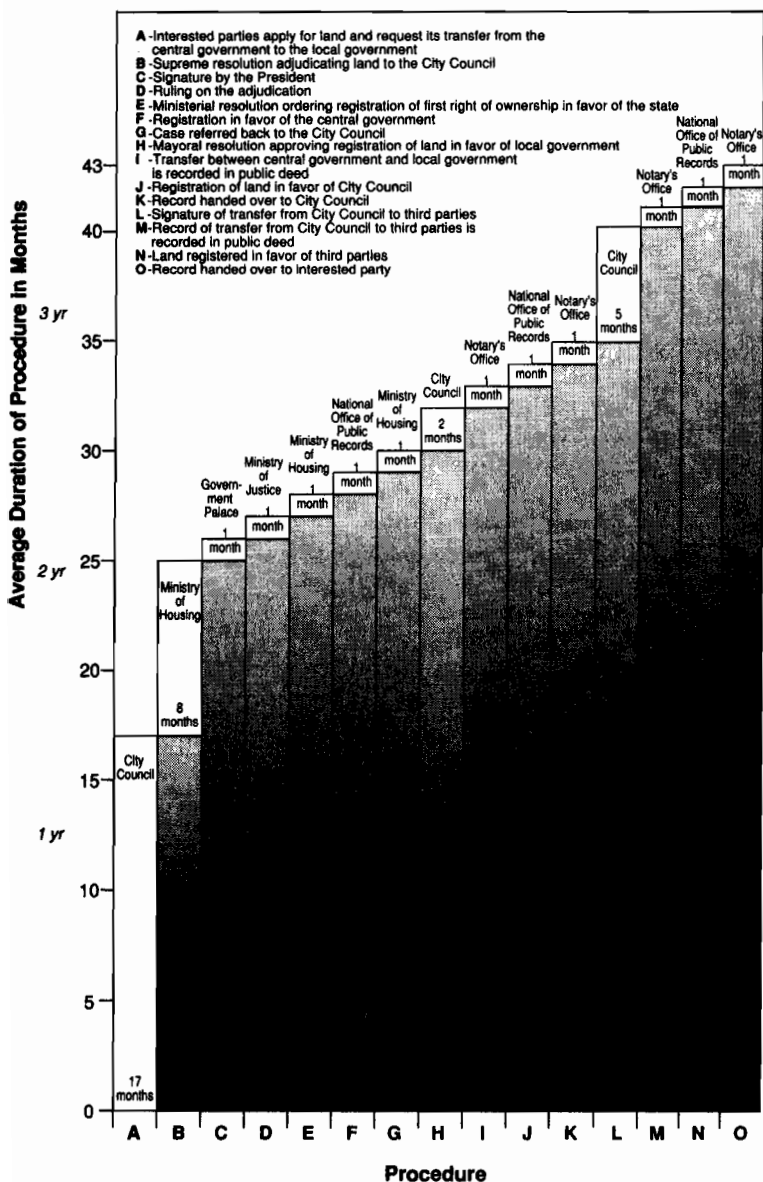
We should also mention that people who acquire state land receive, at the end of the process, a defective title over which they are unable to exercise all the rights which civil law accords to traditional private property owners. For instance, they can sell or encumber the land only with the express consent of the provincial government. This legal discrimination hurts precisely those people who have the least resources and most require the adjudication of state land for their homes.

Do not imagine that this obscure adjudication process is free. It takes time, information, and resources. To calculate its costs, the ILD hypothesized a housing association with 244 members and calculated the costs the



**Graph 2. Procedures for Access to Formal Housing**

Graph 3. Procedures for Adjudication of a Piece of State Wasteland



Procedure

members would have to bear to obtain by honest, formal means a piece of state land on which to live.

According to our estimates, the association must invest \$526,019 in the adjudication procedure. Each member would have to pay \$2,156: in other words, someone who at the time was earning the monthly minimum living wage would have to pay out his or her entire income for four years and eight months.

### *Approval for development of the land*

Once land has been acquired by state adjudication, it must be developed, a "process involving a change of use of rural or waste land and requiring the provision of public utilities."<sup>1</sup>

The land cannot be developed freely, according to the preferences or requirements of the owners or as their finances permit. Any development plan must first take into account the land uses indicated in the zoning regulations and the minimum quality standards and maximum permissible density for basic services. Only when the plan complies with criteria can development begin. As can be seen from graph 5 (page 142), this takes an average of 28 months and involves at least three different stages, all of which must be processed with the Lima City Council: approval of preliminary studies, approval of plans, and authorization of the improvements.

### *Building permits*

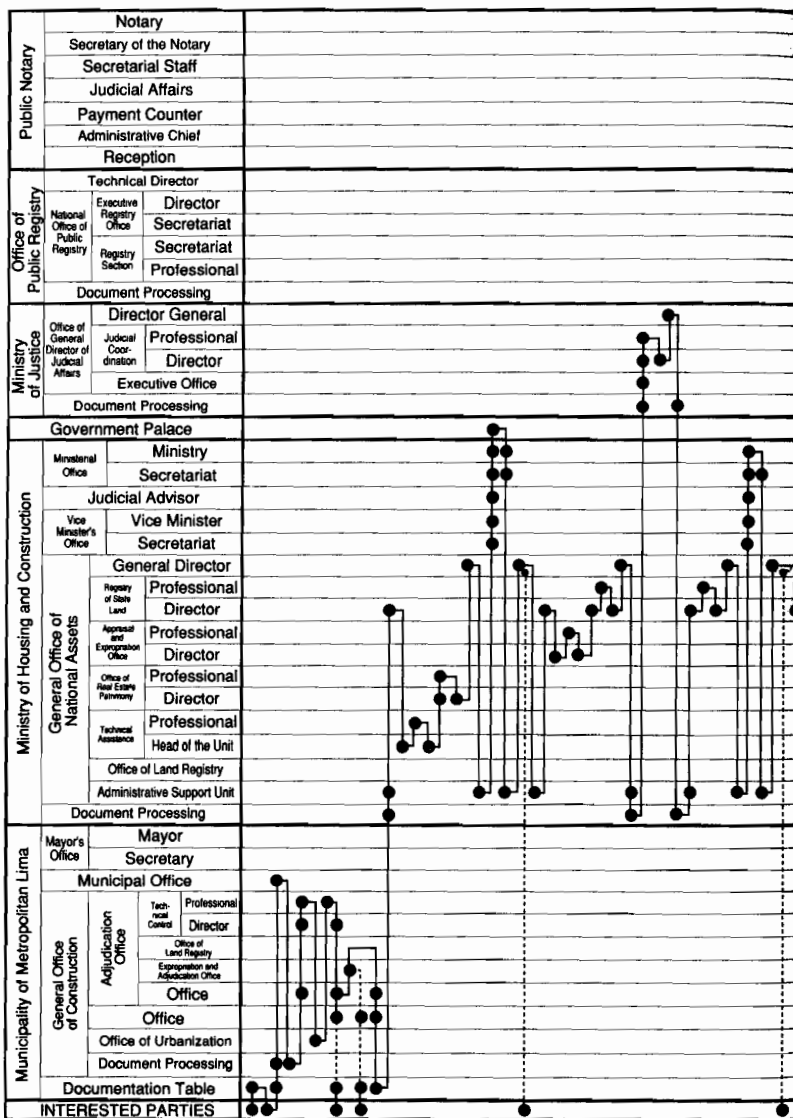
Finally, once the land has been acquired and developed, it must be built on. For this, building permits must be obtained prior to construction and, once construction is complete, certification that it conforms to the earlier approved plans. The ILD found that it usually takes about 12 months to obtain these two documents from the City Council. Graph 6 (page 143) illustrates the process.

Obviously, one reason people invade land and build their homes outside the law is that the legal channel established for gaining access to land for housing is severely restricted.

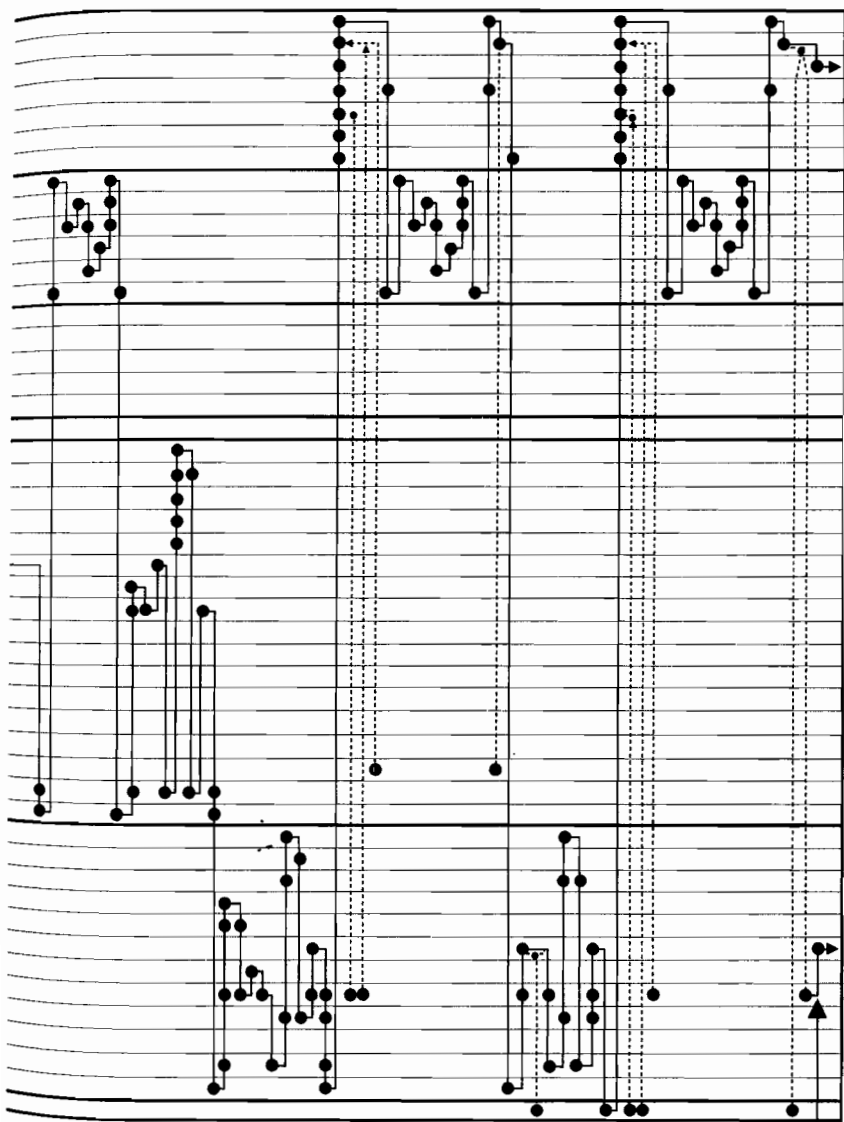
The inefficiency of the restrictions becomes particularly painful if we bear in mind that 5 percent, at most, of the national territory is currently being used for economic purposes. The remaining 95 percent has economic significance only in terms of the value added to it by people. One popular way to add value is to build on it, and it is precisely this course that is restricted by the law.

<sup>1</sup> National Building Regulations II. I.

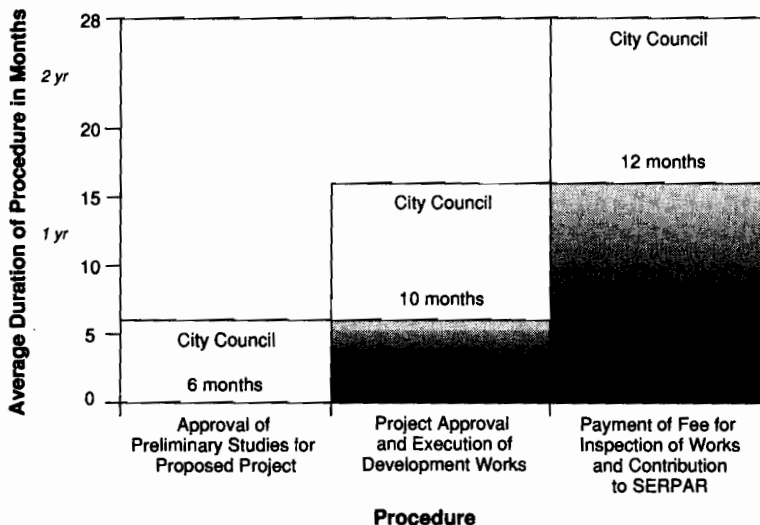
**Graph 4. Sequence of Administrative Requirements for Adjudication of Undeveloped, State-Owned Land**



STEP  
1



STEP  
207

**Graph 5. Procedures for Approval of Land Development**

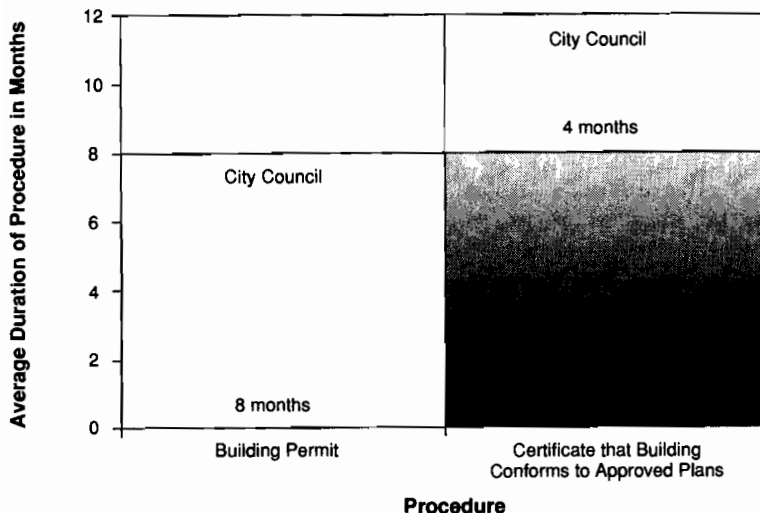
To sum up, the 83 months required to obtain adjudication, a development permit, and building permits must be viewed as the main restriction which makes access to formality so expensive that, for people of humble origin, the only possible course is informal urbanization. This is a typical bad law.

### **The costs of access to trade**

The ILD then examined access to formal trade, since the restrictions that exist are crucial to an understanding of why people in Lima trade informally on the public thoroughfare or in markets. To do this, the ILD studied the two courses open to anyone wanting to gain access to formal trade: opening a store and building a market or shopping center. For the first, we used the same approach as we had in industry: we simulated the opening of a store. For the second, we took the approach we had taken with housing: we went over existing legislation and examined actual markets or shopping centers built by street vendors.

#### **Opening a formal store**

The researchers decided to behave as any person of modest means would, undertaking the various procedures without go-betweens, complying with

**Graph 6. Procedures for Obtaining Building Permit**

all requirements, and trying to avoid paying bribes. The San Juan de Miraflores district was chosen because it is a new, prosperous commercial area with popular roots that go back many years. Suitable premises were rented and fitted out, and the process was initiated.

The simulation showed that a person wishing to open a small store legally must comply with bureaucratic procedures involving three different government departments. This takes 43 days and costs \$590.56, 15 times the monthly minimum living wage in effect on the date on which the simulation was completed. Graph 7 (page 145) shows the results.

These findings show how the regulations create the incentives for choosing informality.

### *Building a market*

The ILD studied five actual cases in which vendors had organized to build their own markets. The sample covered the city's various main commercial locations and areas.<sup>2</sup>

<sup>2</sup> Studied were Libertad market in San Miguel, Colonial market in El Cercado, Miguel Grau market in Independencia, the APECOLIC market in Comas, and Ciudad de Dios market in San Juan de Miraflores.

The exercise showed that the cost of access to formal markets, in terms of time, was an average of seventeen years, from the formation of a minimarket until the market proper comes into operation. If we deduct from this the amount of time it takes vendors to organize themselves informally, the waiting period is still at least 14½ years and could be taken as a net indicator of the cost of access to the market proper.<sup>3</sup> Graph 8 (page 147) gives details of this process.

The difficulties of building their own markets explain why many people decide to be street vendors, for markets tend to appear when the vendors have organized and begun a process of accumulation. However, they explain why many remain street vendors far longer than they otherwise would.

Despite everything, in the last twenty years vendors have built twelve markets for each one built by the state. Were it not for the restrictions, the number of markets built by vendors would have been considerably greater.

### **The cost of access to transport**

Last, we come to the costs of access to transport. Here, things are far simpler than in industry, housing, and trade, but also more dramatic. There simply is no legal access to this activity.<sup>4</sup>

As a result, the ILD did not make a simulation or consider actual cases—since none existed—but turned to the law itself to determine what obstacles existed. The present procedure for obtaining access to formal transport is as follows.

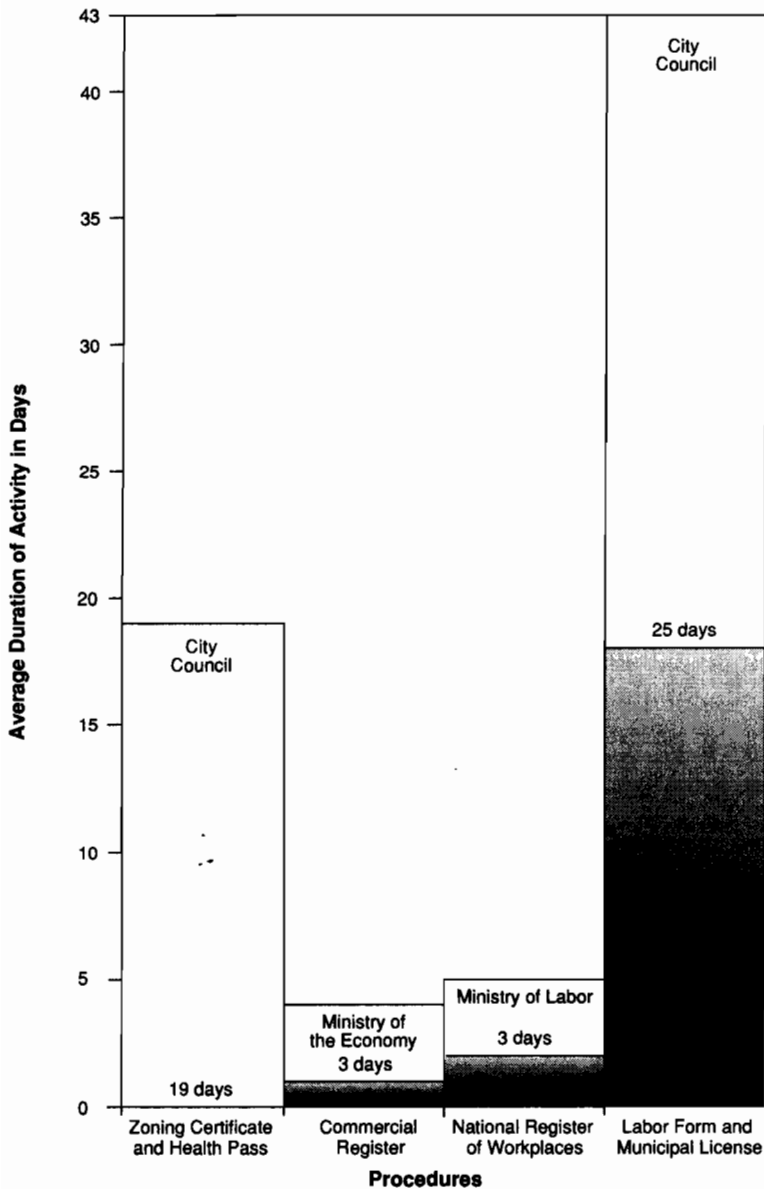
First, only the state has the power to award rights. No group of transport operators can, of its own initiative, establish itself and request a route. This completely eliminates freedom of access to transport activities. Second, only the authorities can decide what routes have inadequate transport services that must be increased. These needs established, no one has the right to apply to operate a service, because the authorities are obliged to offer the new route to the existing committees or the companies nearest it. In the latter case, they acquire new rights and the process takes the form of an extension of the route. Only if authorized transport

<sup>3</sup> According to a large formal business which specializes in building markets, it takes formals approximately 100 days to complete the same procedures.

<sup>4</sup> The procedure used was the one provided by the 1981 regulations. Responsibility for this sector was transferred from the Ministry of Transport and Communications to the City Council in 1984, and a change in the procedure for awarding concessions has been pending. As of the time of writing, the new procedure had not been announced.



Graph 7. Procedures for Setting Up a Formal Store



operators are unable to offer their assistance can the authorities grant new operating rights to third parties.

In the interests of accuracy, the ILD undertook a further exercise based on the hypothesis that there were no legal obstacles but that all the other bureaucratic conditions remained constant and that the Ministry of Transport and Communications was still the department competent to deal with such matters.

To do this, the ILD interviewed ministry officials to get an idea of what a hypothetical procedure for gaining access to transport activities would entail. Two possibilities emerged. First, a group of people might decide to form a committee informally and request a minibus route concession. Second, a group of people might decide to incorporate themselves formally and request a bus route concession.

The procedure for obtaining recognition of a minibus route would take approximately 26 months. To obtain the bus route concession would take close to 27 months. Graphs 9 and 10 (pages 149 and 150) contain details of this exercise.

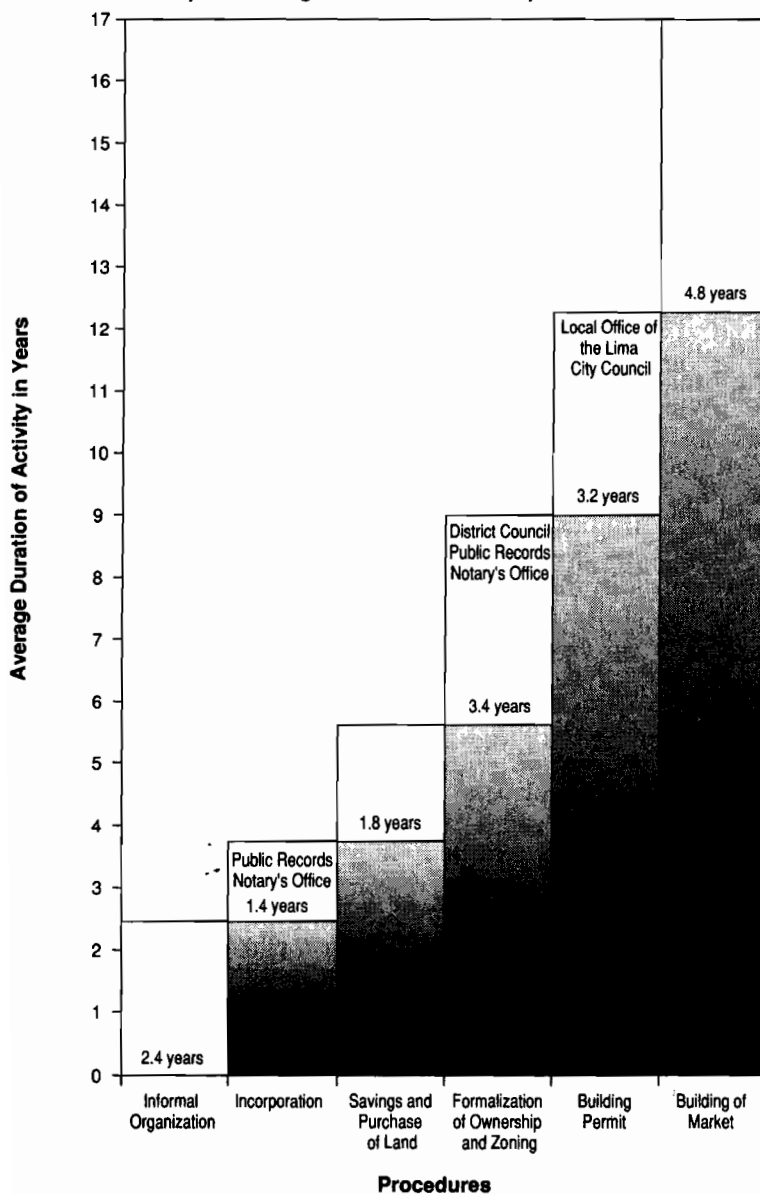
We have summed up the main results of the ILD's research into the costs of access to industry, housing, trade, and transport. As we have seen, these costs are caused by government regulations of varying nature and importance. They were doubtless imposed in a desire to correct the defects of the market and better plan or rationalize private activity but have exactly the opposite effect. They give rise to a number of costs which discriminate against people according to income, ensuring that those who are financially better off enjoy the benefits of legal protection more readily, and that those who are poor are forced to engage in essentially honest activities such as building, trade, industry, or transport without the protection of the law. What we have here is bad law.

### **The costs of remaining formal**

Having established the relationship that exists between people and the law when they enter various economic activities, the ILD investigated this relationship for the duration of the activities themselves. During this period, too, citizens are forced to comply with a number of regulations—in order to remain legal. We have coined the phrase “costs of remaining formal” to refer to this phenomenon.

In its broad sense, this phrase covers a very widespread and complex situation. It refers both to costs directly imposed by the law—taxes, compliance with bureaucratic procedures, obligations to administer per-

Graph 8. Average Time Taken to Set Up an Informal Market



sonnel in a certain way, and payment of higher rates for public utilities, among others—and to costs indirectly imposed by legal institutions as a whole—the instability of the legal system, insecurity of property rights, and the inefficiency of the judiciary in settling disputes or collecting debts, among others. Since it was impossible to cover all these aspects at once, the ILD decided to study indirect costs at some future stage and to concentrate for the time being on direct costs, examining the returns declared by businesses themselves. This analysis was limited to industry.

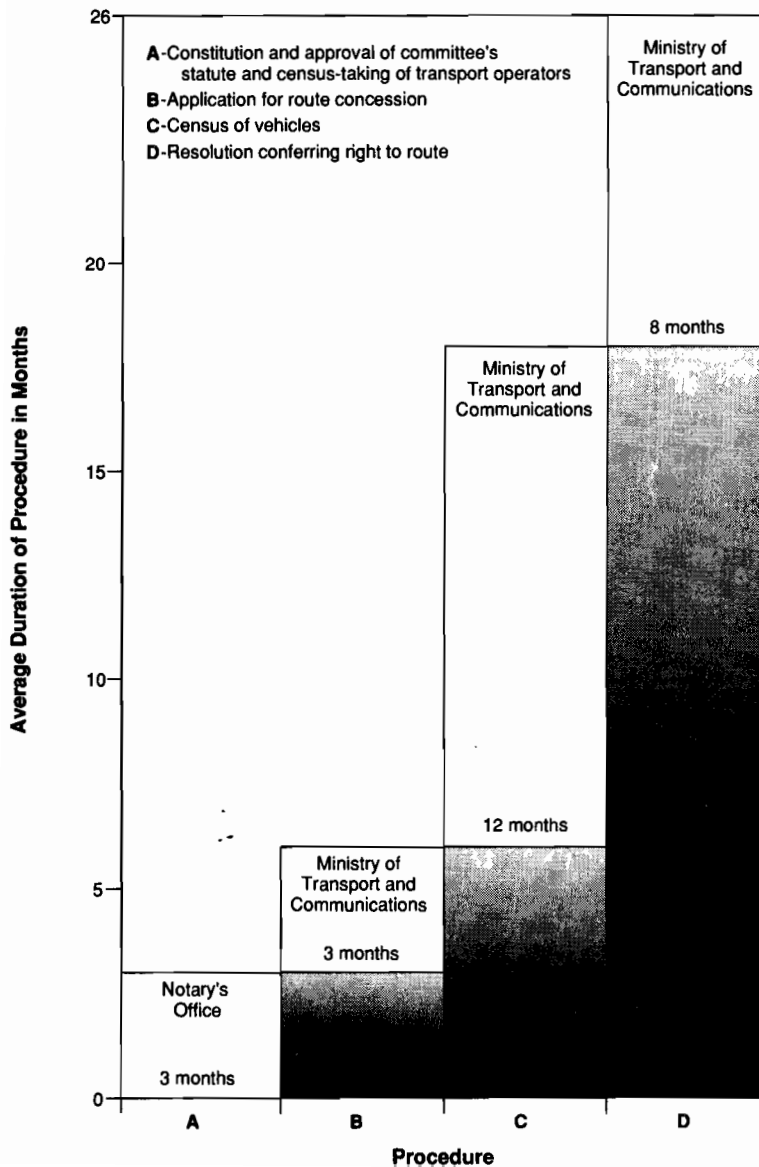
Accordingly, we chose a sample consisting of fifty small industrial firms, employing between one and four workers and engaging in activities where there is a high level of informality: baking, knitting, dressmaking, shoemaking (except rubber or plastic footwear), and furniture making and woodworking.

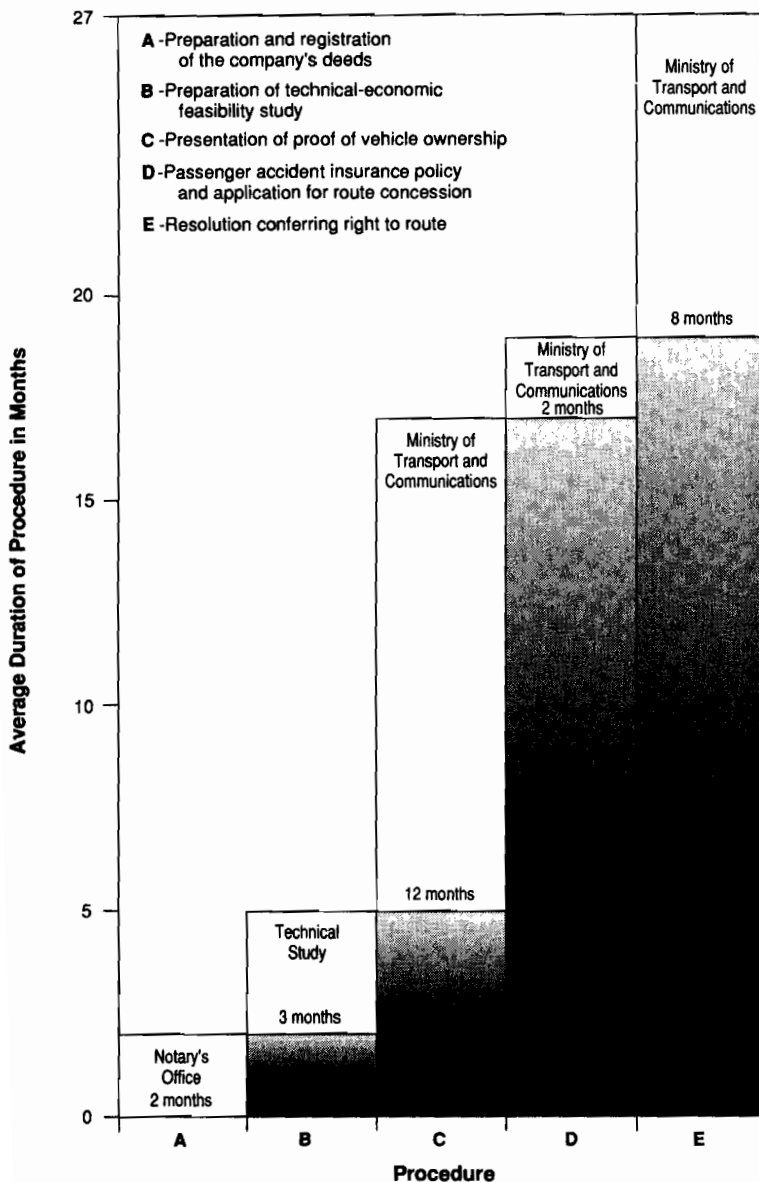
When they analyzed this sample, the ILD's researchers found, that remaining formal costs a small industrial firm 347.7 percent of its after-tax profits and 11.3 percent of its production costs. In other words, were it not for the costs of remaining formal, the firm's profits and therefore its savings and potential investment capital would be more than quadrupled.

The sample provided an indication of the relative importance of the costs chosen for analysis. The ILD's researchers classified these costs tentatively into tax costs, nontax legal costs, and public utility costs. It was found that 21.7 percent of the costs of remaining formal are tax-related, 72.7 percent are other legal costs, and the remaining 5.6 percent are public utility costs. In other words, for every \$100 that a small industrial firm must pay in order to remain legal, \$22 goes to taxes, \$73 to other legal costs, and \$5 to utilities.

The "other legal costs" include the cost of the administrative procedures required to remain formal. To calculate the time taken by these procedures, the ILD conducted a survey of 37 legally established companies operating in areas where there is a particularly high level of informality—for instance, foodstuffs, wooden furniture, textiles and garment manufacturing, chemicals and plastics, printing, basic metal working, mechanics, and toys. It found that companies devoted approximately 40 percent of all their administrative employees' total working hours to complying with bureaucratic procedures. On average, each of these employees devoted two-and-a-half days a week to this task—a tremendous waste of resources.

The costs of remaining formal prevent the surpluses generated by an activity from being distributed freely, and thus affect the companies' potential profits. They can use only \$23.30 of every \$100 of the surpluses

**Graph 9. Hypothetical Procedure for Access by a Minibus Committee**

**Graph 10. Hypothetical Procedures for Access by a Minibus Company**

generated and potentially convertible to profits, and they spend the remaining \$76.70 on remaining legal. Contrary to what one might assume, only \$17.60 of this amount goes to pay taxes; \$59.10 is spent on other legal costs.

First, we can conclude that, since taxation is not the main problem, tax policy is not the prime determinant of whether companies operate formally or informally. Other legal costs are at the heart of the matter. Business people have to satisfy a number of regulations, ranging from processing an endless succession of documents in government offices to administering their staff inflexibly. This appears to have a decisive impact on a business's formality or informality. The ILD's analysis suggests that the intensive use of labor steadily increases the costs of remaining formal, prompting people to use capital rather than labor, intensively. People without capital—who are also unlikely to be able to assume the greater costs of remaining formal—desert to informality. Since it is labor, rather than capital, that is abundant in Peru, the result is an inefficient use of resources which is damaging to the whole of society. There is, in fact, a widespread trend in Peruvian legislation to favor this use of capital, and even the overcapitalization of formal businesses, through mechanisms which make formal employment more costly than the formal use of capital.

We can also conclude that the costs of remaining formal seem to have an excessive impact on the way in which businesses are run, affecting their operations and output independently of the production process itself. By altering the allocation of resources, they make production more costly, limit the mobility of factors of production, and increase the cost of transactions. This alters the profitability of a firm, regardless of its basic economic efficiency. The company's prosperity depends less on how well it does its work than on the costs imposed on it by the law. The owner who handles these costs better or manipulates the firm's relationship with the state better is more successful than the one who is concerned only with the job.

What we have here is bad law.

## The Costs of Informality

As we gradually confirmed the existence of the costs of formality, we came to grasp not only why informals operate outside the law but also the real significance of the extralegal system. If informals wanted to establish a new set of laws, it was because they had lost something by operating outside and

even in defiance of the law. We had to examine what they were in fact losing.

We gradually discovered that informality is not the best of all possible worlds, that it involves tremendous costs, that people try to offset these costs in all kinds of novel but inadequate ways, that lawbreaking is not, on balance, desirable, and that the apparent chaos, waste of resources, invasions, and everyday courage are the informals' desperate and enterprising attempts to build an alternative system to the one that has denied them its protection. This discovery enabled us to devise a complementary concept: the costs of informality.

We shall distinguish here between the cost of illegality, based on the evidence about the main differences between formal and informal businesses or activities, and the cost of not having a good law, the result of a more thorough process of conceptualization in which an attempt is made to identify which efficient legal mechanisms and instruments people had to forgo when they opted for informality.

We have been limited, however, to observations conducted empirically in informal places of work and residences. As a result, we can offer only a general list of limitations which illustrate, and only partially, the tremendous losses inflicted on the country by a legal structure which discriminates among its citizens. Moreover, for the purposes of this analysis, we have assumed that businesses or economic entities are either completely formal or completely informal. In real life, of course, this is not so: many formal businesses are partly informal or carry out informal activities, and vice versa. Some of the cases we investigated fell into these categories, for formality and informality are relative concepts; for the sake of simplicity, however, we will assume that informals have no legal status whatsoever and that formals are completely legal.

## The costs of illegality

Our first attempt was to determine the differences between informal and formal activities or businesses and to establish the most common cost of informality.

It is clear that informal businesses devote tremendous effort to avoiding punishment by the authorities. They do so by means of a number of practices which we will consider in due course. Second, informal businesses make transfers to formal activity without any actual reciprocation from the latter, since they are excluded from its scope and benefits.



Third, informal businesses suffer the consequences of their evasion of certain taxes and labor laws.

In the pages that follow we will present the evidence we gathered on the cost of avoiding penalties, the cost of net transfers, and the costs of evading certain taxes and labor laws. We shall try to explain how the costs that differentiate formals from informals, and thus represent the costs of operating outside the law, arise in practice.

### *The costs of avoiding penalties*

The first significant difference between an owner of an informal business and a formal one is the tremendous investment which the informal must make to avoid detection. Informals constantly run the risk of being penalized for not having obtained permits, paid taxes, or applied for the authorizations required by law. In its interviews, the ILD found that this is the main source of concern among informals. The informal business owner, who by definition has failed to comply with some or all requirements, saves the legal costs of compliance but must bear the cost of avoiding the corresponding penalties.

Informals use various strategies to avoid detection and penalties. Among the main ones, we identified dispersing their employees among a number of smaller and less visible workplaces, not advertising their goods or services, not entering certain markets which are in effect barred to them, and corrupting the authorities. When we visited clandestine factories, we found that the need to avoid detection forces informals to operate on a very small scale. They deliberately limit their operations or, if they need to grow, do so by dispersing their workers so that there are never more than ten in one establishment. While such arrangements obviously help them to avoid detection, they also prevent them from achieving efficient scales of production. This seems to be a fairly widespread consequence of informality.

Informal businesses are undercapitalized, not only because they have no access to credit but also because using certain capital goods makes them easier to detect. Furthermore, it is worth using some of these goods only if there are enough workers to handle them, and this increases the risk of detection.

Another difference between informal and formal business people, also deriving from the need to avoid detection, is that the former cannot easily advertise their goods or services and must make do with concealed, restricted methods of attracting customers, based almost exclusively on their reputation. This helps them to remain unnoticed by the authorities,

but it also prevents them from building their business. According to the U.S. Small Business Administration, two-thirds of all customers are brought in by the signs displayed outside shops or factories. Advertising can also help to offset the disadvantages of a poor location, compensating for the lack of visibility with effective communication. Informals cannot exploit this advantage, either.

In order to avoid detection, informal businesses generally operate outside such legally established markets as stock markets and trade fairs. Moreover, they do not have access to the trade instruments used there, such as shares, letters of credit, or warrants. Thus, anyone interested in dealing with informals must devote more time to gathering information on potential trading partners, thereby increasing the cost of both the information gathering and the transactions. Were they to enjoy these institutional facilities, informal businessmen would be able to negotiate faster and more efficiently, and purchasers would merely have to go to specialized markets to conduct their transactions.

Another major cost of avoiding penalties is that informal businesses must devote a considerable proportion of their resources to corrupting the authorities. While the informal business owners interviewed said they paid out between 10 and 15 percent of their gross income in bribes and commissions, the owners of formal small businesses said they paid no more than 1 percent.

Since 61 percent of the hours worked in Peru are informal, there is obviously a long frontier between the informal sector and the state authorities. Some informal businesses are completely clandestine, but it is inconceivable that 61 percent of all the work done could be carried out illegally without the authorities in some way turning a blind eye. This systematic corruption undermines the principle of authority in the country as a whole. It could be argued, in strictly economic terms and with the necessary dose of cynicism, that bribes replace the taxes which the informals do not pay, for they achieve similar results. However, bribes also involve an undesirable element of misconduct which is absent from taxes.

It could also be said that bribes perform a function far closer to that of insurance, in that they attempt to eliminate the informals' uncertainty about the losses they might sustain if they were penalized by the authorities. In paying a bribe, they are simply buying security from prosecution—a kind of insurance against official penalties. However, there is every indication that these bribes are proportionally larger than insurance premiums because the actual risk of prosecution cannot be

quantified. From a strictly economic standpoint, therefore, they are inefficient.

### *The costs of net transfers*

A second difference between formals and informals is that, unlike what happens in a well-integrated economy, informals make a number of unreciprocated transfers to formals which represent net losses to informality. The existence of these transfers is fundamental to an understanding of why the apparent benefits of evading the law do not yield a greater return than legal business does. In analyzing the situation, we have made a distinction between the cost of taxation and the use of cash assets, and the cost of saving intangible assets.

It is generally maintained that informal economic activity not only competes unfairly with legally established activity, since it saves the cost of formality, but also benefits, without paying, from the public utilities offered by the state, forcing the state to transfer to formal business the entire burden of funding the public budget.

This reasoning is incorrect. The evidence gathered by the ILD shows that there are at least three major channels through which informal activities are constantly transferring resources to the government and other formal institutions: indirect taxation, inflation, and differences in interest rates.

Innumerable transactions take place daily between formals and informals. Although informals do not pay taxes on their sales, they pay taxes each time they purchase something from formals. Since formals invoice their sales, informal purchasers are paying indirect taxes. This does not always happen, for some sales take place without invoices, but there are situations where tax evasion is very difficult. The gasoline tax, for example, is largely borne by informal transport operators.

There are a large number of transactions in which informals are forced to make transfers to the government in the form of sales tax and import duty. The ILD estimates that, in 1985, informal economic activity transferred the equivalent of \$813 million to the government in this form, representing 5.7 percent of the gross domestic product (GDP) for that year and 41.4 percent of all taxes levied on inputs.

Bearing the cost of inflation is another way of paying taxes. Many economists have defined inflation as a tax on money which the government levies on the private sector to finance its surplus spending or budget deficit. When prices rise and the currency loses purchasing power, private individuals cede to the state part of the value of their cash assets. This

process particularly hurts those who hold more of their money in the form of cash, namely the informals, whose transactions are conducted in cash and who use the banking system less frequently—not only for fear of detection but also to protect themselves from the debasement of money—unlike those who keep their savings in hard currency or in interest-bearing accounts. The purchasing power which informals lose by keeping cash in hand is a transfer of resources to formal activity, part of which is funnelled off by the government. The ILD estimates that, in 1985, such transfers totalled \$554 million—3.8 percent of the GDP for that year.

If we add the two transfers together, we find that informals transferred resources totalling \$1,367 million, or the equivalent of 9.5 percent of the GDP, to the state. This amount would have more than covered the central government's entire investments for that year, which came to \$465 million.

Last, transfers are made from informals to formals because of differences in the interest rates paid for credit. According to the ILD, interest rates on the informal credit market in June 1985 were as much as 22 percent a month in Lima, as against the maximum rate of 4.9 percent that a formally established business could obtain from a bank. This disparity in the cost of money is caused by the informals' lack of access to formal credit, which forces them to accept the informal mediation of individuals who can obtain cheap, formal credit which they transfer to informal businesses at excessively high rates. This huge difference in interest rates can be attributed partly to the perceived risk of conducting a financial transaction with an informal business, and also to the fact that the market for informal capital transactions is competitive and the interest rates established tend to reflect more accurately the opportunity cost of using the financial resource.

The difference in interest rates transferred by informals to the rest of formal activity came, in 1985, to \$501 million—3.5 percent of the GDP for that year. We can grasp the size of this transfer more fully if we consider that it was 1.4 times larger than the amount paid by formals in taxes on income and fixed assets.

If we add the transfer represented by the difference in interest rates to the two already mentioned, informals transferred to formals a total of \$1,868 million, or around 13 percent of the GDP in 1985. This alone calls into question the superficial contention that informals contribute nothing to formal society.

One side effect of the use of cash is the cost of saving tangible

assets. Fearing depreciation of their cash assets as a result of inflation which, in the period from 1983 to 1985, was way over 100 percent a year, many informals prefer to accumulate inventories rather than save money. As a result, many purchases of capital equipment, movable assets, and storable merchandise are made before the proper time. Since equipment is indivisible and the costs of capital are high, these advance purchases mean that some informals invest on a far from efficient scale.

We can see this at a glance. The overall impression created by informal settlements, street vendors' markets, and industrial workshops is that they are only half-finished. Buildings are unfinished, construction materials are piled up on the sidewalks, and equipment is incomplete. One might think that this is due to an innate Peruvian laziness, but it is not so. What it means is that informality forces informals to save in materials rather than in money and that the financial system is not working.

### *The costs of evading taxes and the labor laws*

The third difference between formals and informals is that the latter generally do not pay direct taxes or comply with labor laws. This no doubt has economic benefits which may partially offset the cost of informality and even outweigh the benefits of formality. For instance, if the law establishes a minimum wage which is above the level dictated by the market, we can assume that informal businesses will pay lower salaries and wages. This is why informal businesses are the chief employers of unskilled labor.

The drawback for informal businesses is that this prevents them from using anything but methods with low technology and productivity. The advantage is that when the market is depressed they can hire and fire without any problems other than moral considerations or that of losing good workers. Among formals, on the other hand, labor is regarded as a fixed cost; they are prevented from responding to fluctuations in demand as flexibly as informals.

The general sales tax (IGV), however, affects both formal and informal activities. Although it appears to be a tax on gross income, it is actually a tax only on added value, which is why it is levied at each stage of production. At the second stage, for instance, one pays a tax on gross income but receives credit for the payments made at the first stage. This is a major handicap for informal suppliers of intermediate goods. The customer pays the gross tax but cannot obtain credit for the intermediate

good purchased from the informal supplier. This places the informal supplier at a comparative disadvantage.

The IGV, therefore, prompts informals to conduct their activities at the two extremes of the productive process: first, activities where added value accounts for a large part of the total retail sale price, since this offers the advantage of evading the tax precisely when it reaches such a point. Second are activities which occur in the early stages of the transformation process, when the entire value-added tax can be evaded (cultivation of agricultural produce, brick manufacturing, provision of domestic services, and so forth). Informal business owners are excluded from relatively technical areas of intermediate production partly because the tax system does not allow them to benefit from the tax credit. Perhaps the greatest cost is that, in this context, the tax system militates against higher levels of productivity.

### **The costs of the absence of good law**

Having established that there are costs to being illegal, we asked ourselves whether eliminating those costs would be enough to transform informality into the best of all possible worlds. The following exercise convinced us that this is not true and that informals suffer not only from their illegality but also from the absence of a legal system that guarantees and promotes their economic efficiency—in other words, of good law.

When clandestine factory owners do everything they can to avoid detection, when informal settlers waste time and effort on defending their property and complying with the procedures necessary to legalize it, or when street vendors cannot offer acceptable guarantees to finance a market or buy on credit, it means that they do not have the property rights or secure contracts needed to organize their economic activity efficiently. That society as a whole suffers from the adverse effects of informal activity, also demonstrates the absence of a workable extracontractual legal system.

It is essentially these three elements—property rights, contracts, and an extracontractual legal system—that a good law should provide. The absence of such a law creates an extremely burdensome set of costs which informals must bear in exchange for not paying the costs of formality.

### **The costs of not having property rights**

Traditionally, in Peru, property rights have been understood as those which confer on their holders the power to use, enjoy, dispose of, and claim a tangible or intangible asset within the framework of the law. A more

superficial interpretation has limited even this concept to movable or immovable assets. We wish to give it a broader meaning here, however, based principally on its economic importance.

Classical legal theory holds that individuals can, essentially, enjoy real and personal rights, the former in relation to things, through ownership, possession or usufruct, among other ways, and the latter in relation to other people, through contracts. This division has overcompartmentalized the real situation, for it gives the impression that there is no connection between the two groups of rights. We see the main connection as being that individuals may own or possess not only things, but also contracts. Accordingly, there is in each personal right an implicit real right which connects it precisely to the subject of that right.

This means that property rights may relate not only to houses, cars, machinery, or merchandise but also to rental agreements, foreign currency certificates and their free convertibility, and all sorts of credits, with the result that property rights can be lost not only through confiscation or expropriation but also through more sophisticated and apparently innocuous regulations such as tenancy laws, freezing of savings, or measures against speculation.

Thus, by property rights we mean all those rights, both personal and real, which confer on their holders inalienable and exclusive entitlement to them—in other words, the power to enjoy them freely, to dispose of them freely, or to use them to the exclusion of all others. Having said this, it becomes obvious that the most significant cost of the absence of a good law is the absence of secure, reliable property rights. We shall therefore explain the three main conclusions we have been able to reach and which will enable us to identify more readily the costs that the informals must assume because they do not have these rights.

Our first conclusion is that informals do not use or preserve the resources available to them as efficiently as they might if they were sure of their rights. If they cannot enforce their rights to land, housing, and equipment, their incentives for investing in them are considerably reduced. People build less if they think there is a risk that the state or another person might take away or occupy what they have built, just as no one invests in costly innovations if anyone might later appropriate their invention without compensation. The effect of all this is to reduce aggregate investment.

Secure property rights, on the other hand, encourage holders to invest in their property because of their certainty that the property will not be usurped. From a strictly economic standpoint, therefore, the true purpose

of property rights is not to benefit the individuals or entities holding those rights, but to give them the incentive to increase the value of their assets by investing, innovating, or combining them advantageously with other resources, something which would have beneficial results for society.

This was confirmed by the ILD's field work in Lima's informal settlements. As we saw in the chapter on informal housing, when the Mariscal Castilla and Daniel Alcides Carrión settlements, which have similar socio-economic characteristics, were compared, it was found that the value of housing in the former was 41 times greater than in the latter because of the legal security it enjoyed. A larger sample, 37 settlements, later revealed that the ratio of the value of settlements with title and those without is 9 to 1. Everything indicates, then, that the existence or absence of property rights has a direct bearing on the level of investment.

The second conclusion is that informals cannot transfer their property easily. They cannot use it for more valuable purposes or as collateral. This limits their property's mobility as a factor of production and reduces its productivity.

The third conclusion is that informals incur substantial costs in defending their possessions and satisfying the need for public property by establishing and operating thousands of different organizations. These informal organizations involve a tremendous investment of time and other resources; moreover, they do not have the authority to force delinquent members to contribute to their operating costs.

Many of the decisions made by such organizations require a majority. But when each owner has only one vote, serious difficulties may arise because the differing intensity of each voter's preferences is not taken into account. Let us take the case of an informal settlement where there are plans to build a street costing \$3,000. Of the fifty families living in the settlement, ten set a value of \$200 on the building of a street and the other forty set a value of only \$50. This means that the community as a whole has set a value of \$4,000 on the road, making the road profitable because the valuation exceeds the cost of building it. But suppose the proposal is that each family will bear a fixed share of the cost, \$60. It will be rejected because forty of the fifty families will consider themselves net losers since they value the project's potential benefits to them at somewhat less than that amount. Thus, while relatively efficient at administering individual property, people living in informal settlements lack the administrative and levying mechanisms to develop and pay for collective projects. The state would solve the problem simply by forcing everyone to pay in the form of taxes.



Of course, there are other ways to solve such problems, but they are generally more costly and less reliable. For instance, the decision may be to build roads and sidewalks only in front of houses whose owners have made their payments. But this can put a noncontributing member in a bad light. In such a situation, the informals' inability to reach legally binding agreements increases their difficulties.

In some adverse situations, a spirit of cooperation emerges which enables community leaders to demand of their members an altruism which permits surprisingly high levels of cooperation. But the fact remains that the absence of coercive mechanisms substantially reduces the potential scope of an informal partnership. In other words, although there are people who are highly altruistic, there are also conflicts of interest which cannot be resolved by informal coordination.

If we take the above three conclusions into account—that informals do not use or preserve their resources efficiently; that they cannot easily transfer their properties, use them for their more profitable purposes or offer them as collateral; and that their collective organizations are unable to compensate for their extralegality—it will be easier to grasp the cost of the absence of property rights.

We shall now turn to the cost of access to informal activity. The first is the cost of access to land for building, whether by invasion or informal sales, as well as of the long process of consolidation of rights which, as we saw in the chapter on housing, begins with the expectative property rights and ends with legally recognized property. As you will recall, informals gain access to land without simultaneously acquiring a stable legal right to either that land or anything they build on it. The threat of eviction hangs over them for a long time, until they win full recognition of their rights. Even though the likelihood that this land will be recovered by the state or by private individuals is, in most cases, fairly remote, it remains a continual threat which reduces the settlers' incentive to invest.

As a result, informals tend to invest in such items as household electrical appliances and vehicles, which are movable, rather than in such fixed items as piping, drainage, or roofing. It is not unusual to find motor cars, televisions, and other appliances in informal settlements with shoddy buildings. It is hardly surprising, therefore, that no investments are made in sanitation, with serious consequences for everyone's welfare.

The absence of public registers of the property rights of informals makes it even more difficult to establish the validity of a claim. There are a number of reasons for this. First, it is more difficult to locate legitimate debts which are backed or guaranteed by the property in question, since

there is no central register of such transactions. For the same reason, it is more difficult to defend oneself against a third party's claim to the property. Third, there are valid disputes over ownership and no register in which to research their history.

Informal registers exist in many settlements, but in others they are far from complete. As a result, informal transfers of property create difficulties. For example, a person's expectative property right may be respected by neighbors and third parties because of certain personal characteristics such as being well known in the community. An unequivocal right to the property is not recognized, however. In other words, the claim to the property is based on informal ties which are very difficult to transfer to a potential buyer. In such a case, a potential buyer will have to devote time and money to ascertaining to what extent such factors bear on the validity of the expectative property right and to learning whether the buyer can defend that property with the same skill and at the same low cost as the seller. As we saw in the chapter on housing, one widespread method is to attend meetings of neighborhood organizations and be introduced by the seller as the new owner of the land, agreeing to the terms of the invasion contract and any supplementary agreements.

By extension, the same reasons inhibit the use of property as collateral, one of the various benefits traditionally conferred on property owners. This is because a lender must make the same costly investments as a purchaser in order to make sure that the property is under the borrower's control and that, in the event of a default, the property can be obtained with the same rights as those enjoyed by the present owner. This increases the interest rate charged by lenders for loans guaranteed by an expectative property right or its equivalent; worse still, it may simply prevent such transactions from taking place.

The difficulty of transferring an asset always reduces the incentive to invest further in it, since informals must possess property for a long time before their right to it can be legally recognized. Formals, on the other hand, can add to the value of an asset without envisaging long-term possession, since their right is recognized from the outset. There are formal contractors who invest in land in order to develop it, build on it, and sell it as soon as possible. The contractor can even specialize in large-scale development and infrastructure, thus taking advantage of the economies of scale offered by mass production. This is an advantage which informals do not enjoy.

The few informal contractors that do exist undertake such operations only at considerable risk. A customer who has pledged to buy a building

can have a change of mind and withdraw at any stage of the project, and there is no legal means of obtaining compensation. The purchaser can make down payments and in the end not receive the house that was contracted for.

Finally, informals are forced to reverse the procedure followed by formals: instead of acquiring land legally, developing it, building on it, and finally moving in, they begin by moving in, then building, then developing, and it is only at the end of a lengthy process that they acquire legal ownership of the land. Such a process is obviously totally uneconomical.

### *The costs of the inability to use the contract system*

Economically speaking, contracts are means of organizing and transferring property rights, for they enable parties to pool human and material resources in order to produce goods or services which can then be used to maximum advantage. As such, they are another of the mechanisms that a good law must provide.

Contracts can be classified schematically into two groups: those binding two or more parties among themselves through the pledging of assets, and those which, while also binding on the parties through the pledging of assets, create a separate legal entity for consolidating and executing the relationship. The former are ordinary contracts, such as sales contracts or contracts of deposit, and the latter are partnership agreements creating such business organizations as limited companies, limited liability trading companies, or cooperatives. An efficient state can facilitate the ways in which property rights are transferred and organized between private individuals, either by requiring all agreements reached between the parties to be enforceable before the state authorities, or by providing them with legally authorized forms of standard business organization.

It is precisely these facilitative legal instruments that informals lack and the absence of which is so costly to them. Let us first consider the costs associated with the inability to make full use of ordinary contracts, and then those resulting from the absence of formal business organizations.

The empirical work done by ILD's researchers demonstrated clearly that it would be difficult for a court to enforce the contracts used by informals, either for lack of evidence—these contracts are generally oral—or because the parties are inhibited by the relative illegality of their activities. The result is that informals try to minimize the damage they may suffer from one party's failure to comply with a contract. They must forgo

setting up businesses larger than they currently operate or they may resort to an alternative to legal coercion to enforce contracts.

Contracts which are legally enforceable lend credibility to people's pledges and sometimes specify the penalty a defaulting party must pay. The mere fact that contracts can be enforced encourages the parties to make reasonable commitments that they can fulfill and discourages unrealistic pledges intended to persuade the other party to make a commitment. A legal system which gives all citizens ready access to efficient law courts is a proven and appropriate means of facilitating transactions between people.

Another advantage of legally enforceable contracts is that they enable the parties to enter into beneficial long-term commitments. For instance, if a business owner has the contractual assurance that a customer will buy a given quantity of goods over a period of time, the owner will be able to invest in the machinery and equipment needed to produce the goods and, at the same time, pay off the debts incurred in financing such machinery.

The owner of an informal business who invests in machinery, on the other hand, assumes a far greater risk either because of the fear of detection or because the contract is difficult to enforce. Depending on how the owner evaluates the risk of noncompliance by the customer, the decision may be not to invest in the equipment, to the detriment of both the business and the rest of society. The customer cannot be sure that the owner of an informal business will honor the prices originally negotiated, either. The owner, if the customer has no alternative source of supply, may raise the original price on the very day on which the goods are to be delivered. Fearing such a situation, the customer assumes the risks of the agreement only if the profit is sufficiently great. These limitations so increase the cost of transactions that some of them simply never take place.

It was also observed that the cost of not having legally enforceable contracts increases when a business is being conducted on a large scale. For instance, the owner who wants to obtain the capital needed to purchase more machinery must first offer certain guarantees to lenders. Since it is highly unlikely that an informal will have the necessary documents, lenders cannot be sure that they know all there is to know about the borrower's debts and commitments. They charge higher interest rates than they charge formal businesses because this is the quickest way to cover the risk involved in the absence of formal guarantees. Informality, then, virtually prohibits the use of economies of scale in almost any situation.

However, as we saw when we described the extralegal system in the three previous chapters, informals have managed to generate a set of norms to regulate their activities. While these ingenious substitutes arouse the enthusiasm of some social scientists, they do not function as well as an efficient legal system. Our interviews enabled us to identify the alternative methods used by informals to increase compliance with contracts. One is to invest time, effort, and money in cultivating long-term friendships. An informal business owner who is committed to purchasing from a supplier on a continuous basis hopes to encourage the supplier to make each delivery on time. This works for both parties, for the purchaser has the same incentive as the supplier to honor the commitment. To penalize noncompliance, either party may resort to publicizing the other's default to third parties, thus damaging a reputation. There is nothing very new about this: even among formally established businesses, adverse publicity is an important coercive method which works best when it is used in a relatively small and well-defined circle where everyone knows each other.

This informal method of coercion has definite limitations, however. First, it takes a lot of time and effort to establish a reputation or a sustained relationship, and the latter is restricted to parties wanting to enter into a contract. People who have only recently become established in a market are not trusted by suppliers or purchasers because they have not established a reputation. We found that suppliers often do not provide newcomers with the same quality of products or do not supply them on time, because they give preference to established customers. Only when newcomers have conducted an appreciable number of transactions can a potential long-term relationship become an efficient incentive. In early transactions, the informals incur higher costs because their lack of reputation prompts other parties to breach contracts and charge high interest rates and high prices.

Even if a newcomer is gaining a reputation, we have seen that, for reasons that are difficult to predict, another party may choose not to comply with the contract. As everyone is aware of this risk, owners of informal businesses tend to diversify their sources of supply and sales markets more than formals. Instead of buying a thousand fasteners from one supplier, an informal garment maker will buy two hundred from five different suppliers. The suppliers are thus producing at inefficient levels, making unit costs higher and proportionally reducing their opportunities to employ workers.

Even after a good commercial relationship has been established, one

of the parties may lose confidence in the other. Before a relationship ends, it is very possible that one of the parties may act in bad faith. If the fastener supplier believes that the garment maker will not reorder, the supplier may decide not to deliver the final consignment even though a down payment was made. The garment maker, on the other hand, may not pay for the final consignment because it no longer seems necessary to maintain the relationship. If both parties are aware that they can breach the contract with impunity, the situation can easily deteriorate. Such fears may be enough to prevent the commercial relationship from ever getting off the ground, or to prevent both parties from making as much profit as they could have made had they been able to sign a formal contract.

Another alternative used by informals to increase compliance with contracts is to invest a lot of time in investigating or monitoring the other party. In our example, the garment maker may try out every one of the fasteners ordered. This procedure may be reasonable in the context of an informal business, but it is a costly way to achieve an objective which, in the formal sector, would merely require a guarantee of quality. In the absence of such a guarantee, the owner of an informal business has to be constantly on the alert, whether or not the goods are defective. This is a waste of resources.

Another way of reducing the possibility of a breach of contract is to deal only with relatives or people from the same region. Owners who have suffered a breach of contract will turn to their families, neighbors, or other friends in the justified expectation that the group will pressure the guilty party to offer compensation for the damage done. Similarly, a person newly arrived in the city soon realizes that it is difficult to find anyone other than a relative or someone from the same region who will enter into a contract. It appears, from the interviews we conducted, that the most successful migrants are those who had established, influential relatives when they came to Lima.

We also noticed a widespread tendency to "incorporate" friends into the family in order to make relationships more secure. An older person with whom a close but respectful relationship is established is often called "uncle," and a close friend of the same generation is called "cousin." It takes a fair amount of time and resources to establish and cultivate a wide network of friends, "uncles," and "cousins," and this hinders the development of wide, efficient markets. As a result, production, labor, and capital markets tend to cater to small groups of people who have been recommended rather than remain wide open

and so achieve both economies of scale and increasingly efficient specialization. This reduces the purchaser's ability to compare costs and quality among a large number of suppliers and also reduces the producers' incentives to operate more efficiently and expand their markets.

Another alternative way to increase compliance with informal contracts is to organize collective bodies, such as neighborhood organizations, street vendors' associations, or minibus committees to execute agreements or contracts between their members. The group replaces legal institutions and the state's power to ensure that agreements are executed as agreed. However, the coercive capacity of such organizations is always less than a good judicial system. It is also costly and difficult to establish mechanisms parallel to the judiciary which enable the community to review and determine the validity of a complaint. Moreover, these private tribunals cannot force witnesses or parties from outside their community to give testimony, and they are therefore less competent to establish the fact, settle a dispute, or solve problems between members of different groups. These organizations also have to cover the cost of devising their own rules and publicizing them among members of the community.

The drawbacks of informal systems do not mean that reputation is not an important incentive for complying with contracts, however, even among formals. Formal operators are more prepared to do business with or lend credit to people with whom they have more than just economic ties, and formal buyers also investigate and monitor the quality of materials bought from their suppliers. The difference between formals and informals is one of degree: reputation is more important and contractual uncertainty is greater when access to efficient tribunals is limited.

The last alternative used by informals to ensure that contracts are honored is the threat, and occasional use, of violence. If we assume that our garment maker has only recently gone into business and can do very little to ruin the reputation of a well-established fastener manufacturer who has breached a contract, there may be no alternative but to send some thugs to beat up the supplier. In an informal market, where there is a lot of movement, there is a fairly large demand for coercion against those who breach contracts. Violence is used for several purposes. Instead of paying a group of thugs to ensure compliance with a contract, something which is already undesirable, business owners often pay thugs to ensure that violence is not used against them. Since there is

nothing to prevent this violence from also being used against formally established business owners, the situation also imposes costs on society as a whole.

Their informality also prevents owners of informal businesses from reaping the benefits of legal partnerships. They thus lose an important means of pooling their resources and increasing their economic worth. It is these two functions which make legally established business organizations, whether limited companies or cooperatives, so important economically.

Economic value is created by transforming inputs into outputs. Shoemakers, for instance, take their labor (work hours), money (financial capital), tools and leather (physical capital) and transform them into shoes. One person, working alone, can produce relatively little, which is why it is important to divide the work among several people; two or more people can often do a job far more efficiently if they work together than if they work separately. As a result, the key to creating value is to pool labor, capital, and ideas on an efficient and lasting basis. Let us take an example to illustrate the importance of this process.

An employee who sells his or her labor to a business owner for a long period of time will naturally come to specialize in this particular line of work. As time passes, however, the worker runs the risk that this specialized labor will be less useful to other employers, and will therefore demand a measure of job security from the employer. The owner, who has invested in training the worker, may therefore agree to conclude a long-term employment contract with the worker in order to protect that investment.

The situation becomes more complicated when it involves financial capital, since a very short-term loan, perhaps one that has to be repaid within a week, does not allow a business owner to develop an idea, put it into practice, and then reap the benefits. Furthermore, financing a business may require dozens or hundreds of lenders or investors, all of whom will be aware of the possibility that the borrower may later be unable to repay them, and none of whom will be able to supervise the owner directly. This is why we have business organizations. Such organizations make it possible for long-term commitments and transactions between employees, customers, lenders, suppliers, and investors to be defined in a partnership agreement, so that they can be combined, executed, and supervised through such responsible intermediaries as the managers and directors of the business.

Business organizations are, thus, a combination of standard contracts



which legal institutions make available to people so that they can conduct their transactions more efficiently. We might say that they are like mass-produced garments, but made as the interested parties would have wanted them if they had the time and imagination to have them made to measure. By establishing rights and obligations among a number of parties within an operating framework which permits inputs to be pooled on a productive and long-term basis, the law is a requisite for any major investment.

The difficulty of obtaining access to legal means of organizing inputs and distributing risks, sharing responsibilities, and conducting long-term economic activities is a tremendous limitation of informal activity, for it forces production to remain very small, reduces the range of goods provided, and permits the use of few technological advances. Informal owners cannot pool several people's property, administer it collectively, and ensure that the business survives the death or withdrawal of a member or of the manager. It is hardly surprising that the ILD was unable to find any large informal businesses operating with substantial capital and modern technology.

Among the many advantages possessed by business organizations are limited liability, shareholding, and share capital. We shall consider briefly what it means to informals to be excluded from these benefits.

In partnership agreements, formal business owners can limit the risks of their own commercial participation in a business whose liability is limited to a specific amount of capital. Owners of informal businesses, however, cannot limit the risks of their operations by establishing a legal entity separate from themselves and, as a result, cannot limit their liability to the amount of their share in the ownership of the business. Their personal finances have no protection if the venture is unsuccessful.

Because they do enjoy these benefits, formal entrepreneurs can assign resources more easily, establish definite spheres of activity, and divide their business ventures among different business organizations so that the possible failure of one business will not affect the others. Moreover, limited liability makes it easier to deal with a commercial, financial, or industrial partner because it makes it possible to define the scope of the business and the limits of the guarantees without having to investigate all of the owner's possible relations; the other parties simply have to examine the books and accounts of the business with which they are dealing.

Financiers are generally reluctant to deal with informals and do so

only at very high interest rates and on limited occasions, for they have no way of limiting the scope of their relationship to a legally defined financial sphere, which would obviate the need for them to inspect all the possible assets and liabilities of the informal who is requesting financing.

The owners of informal businesses cannot use the share system, either. Since they have no shares, they cannot transfer ownership of the business simply by selling deeds representing its capital. They also cannot use this system to share the risks of the business among different partners. Nor can owners of informal businesses enjoy the rights inherent in shareholding. There are no shares to pledge as collateral for a personal obligation, no shares that can be encumbered with an usufruct so that a third party can reap the benefits while the owners retain their ownership; no shares with which minority partners can protect themselves; and no way to challenge, in court, management decisions which are thought to violate individual interests.

Nor can the owners of informal businesses increase their capital by bringing in new partners, because they do not have an abstract mechanism like stocks for sharing ownership. Since shareholding does not exist among informals, they cannot buy part of a business—only machines and individual elements of it.

Similarly, the owner of an informal business cannot convert debts into shares, thus losing the possibility of overcoming temporary difficulties by relinquishing part of the business rather than the entire business, a possibility which the law offers to formally established businesses.

Last, since they are not legally established, informal businesses have great difficulty in obtaining insurance policies to reduce their risks. While an informal, like any citizen, can obtain insurance for himself or herself, additional requirements are usually imposed on businesses: official accounting, stock-keeping, and proper registration, for example. Insurance companies also impose what they call "ethical" requirements, under which policyholders must comply with the laws in force. When a minibus crashes and the operator's vehicle is destroyed, when an informal's factory burns down or a house collapses, the loss is irreparable. If they had insurance coverage and could share their risks among a large group, today's owners of informal businesses could extend their activities.

In sum, if such facilities were accessible to the owners of informal businesses, they would be able to increase their business and organizational capacities and obtain greater financial resources to run and expand their

operations. Private investors would then have more ways of investing their capital and increasing and diversifying its returns. These facilities cannot be perfected in a country like ours, because of the restrictions on capital markets, the defective administration of justice, and many other institutional shortcomings. Not even major companies fully enjoy these legal facilities in Peru.

### *The costs of the inefficiency of extracontractual law*

The third cost arising from the absence of facilitative law has to do with the inefficiency of extracontractual law. This type of law relates to damages not covered by contracts and thus protects everybody's interests.

Informal activities affect the community as a whole, without there being an administrative apparatus to correct them. In other words, they are costly to the public at large.

Let us consider transportation. As we saw in the chapter on informal transport, the care with which minibus operators drive their vehicles affects the well-being or safety of many other people. Theoretically, the minibus operator could negotiate with the other drivers and pedestrians travelling around the city each day and reach an agreement to take care and prevent accidents which took all their interests into account. In practice, however, this is unworkable: for a two-mile route alone, the driver might have to negotiate with more than a hundred other drivers and, depending on the location, perhaps thousands of pedestrians, in addition to first ensuring that it is actually they and not others that will be encountered on this route. Some authority would first have to establish the rules of the game (all vehicles should proceed on the right, pedestrians should walk on the sidewalk and cross only at pedestrian crossings, and so forth).

Traditionally, it is the state's function to reduce the risk of damage or injury resulting from any individual's activity. There may also be private solutions, insurance for instance. The two solutions may be combined: the law may require individuals to take out insurance policies to provide compensation in case of accident. Compulsory insurance of minibuses can cover the risks to passengers, pedestrians, and the drivers of other vehicles. They, by dealing with an insured business, are negotiating with a legally liable party whose negligence can be satisfactorily compensated by insurance. Furthermore, the insurance company would automatically put pressure on the drivers by increasing their premiums if they had many accidents or were manifestly irresponsible, and might in extreme cases cancel a policy.

We can also gauge the importance of extracontractual law from the differences between the development of informal housing and informal transport. As we saw, in both cases, the informals' behavior reflects their energy, initiative, and organizing skills, elements essential to success in business.

Both activities begin with invasions prompted by the perception of opportunities and the desire to satisfy an expanding market. However, Lima's residents generally view informal transport as doing them more harm than informal housing, for informal settlers can control their settlements far better than minibus drivers can control the public consequences of their actions. The residents of informal urban developments are both the builders and the occupants of their homes, and thus the ones most likely to suffer from the consequences of untoward actions. Anything harmful is immediately perceived and can be corrected. As sociologists would say, informal settlement dwellers are able to "internalize" the consequences of their actions.

By contrast, minibus operators are only one of many groups affected by the urban transport system which they themselves established. The users of this system as well as those who use the public thoroughfare daily, as pedestrians or passengers of other vehicles, also have an interest in seeing it operate properly. Since they do not belong to minibus operators' organizations and are far too heterogeneous a group to organize in their own interests, however, their only means of protection would be through the law. When this is not available, what we get is a minibus service which is good and efficient in terms of fares but tremendously insensitive to the rights of other users of the public thoroughfare. Because the minibus operators have no way of internalizing their problems, as settlement dwellers do, a system of extracontractual law is needed to represent the interests of others. But it does not exist.

When there is no extracontractual law to cover informal activities, or such law is inadequate or improperly used, informal economic activity can be very costly to the larger community. This reduces the value of its social contribution and increases its uncertainty. As we saw in the chapter on transport, the high rate of deaths and injuries and the serious deficiencies in safety—and there are analogous problems in other informal economic areas—prove beyond a shadow of a doubt that the law is inefficient. Moreover, in such a situation, lawbreaking becomes so widespread that even formals begin to follow suit and safety levels plummet dramatically, endangering society as a whole.

## The National Economic Consequences of the Costs of Formality and Informality

Having gained an idea of the costs of both formal and informal activities, we discovered that this division of activities has other adverse effects on the economy in general, the main ones being declining productivity, reduced investments, an inefficient tax system, increased utility rates, limited technological progress, and a number of difficulties in formulating macroeconomic policy.

### Declining productivity

As we saw when considering formal businesses, excessive government interference results in a great waste of resources. Businesses must devote considerable time to complying with government regulations, and the many restrictions affect the flexibility of decision making and cause resources to be used inefficiently. Productivity declines.

It is difficult to be productive when government restrictions hamper the pooling of resources, when taxes and tariffs distort the price of materials and products, and when price controls distort production incentives. The same is true when red tape, including accounting requirements and other procedural rules, increases costs and when labor laws render the mobility of labor virtually impossible, making it extremely costly to engage new staff.

Informals may sometimes be able to use their resources more efficiently than formals. We know that when informal businesses avoid regulatory impediments, they are more productive than formals. We also know, however, that the costs of informality, including more expensive capital and the absence of facilitating legal instruments, generally result in lowered productivity. The fact that these businesses are more labor intensive than capital intensive reduces their productivity still further, as ILLD's researchers found: they calculated the informals' productivity as a third of the formals.

Furthermore, when labor and social regulations increase the cost of labor, formal companies will respond by using less labor and more capital. In other words, their ratio of labor to capital will be lower. This means that formal businesses do not take advantage of the country's most important productive resource—its labor—and that the country offers its citizens fewer opportunities for employment.

In informal activity, on the other hand, the ratio of labor to capital is

too high. Informals have too much labor and formals have too much capital. This produces an arbitrary and inefficient specialization of the country's resources, for productivity becomes optimum only when decisions are based on the best combination of employment and capital.

### **Reduced investment**

Informal activity is known to have two consequences which reduce aggregate investment. First, informal businesses use more labor-intensive technology, which significantly reduces capital investment in general, for business is moving to informality. Second, in view of the difficulties which informals face in enforcing their contracts, and the high rate of return which financiers require of informal investors, there will be little long-term investment in production. The cost of formality also results in lower levels of investment.

We conclude, from the difficulties which both formals and informals face in achieving optimum economies of scale, that there is a lower level of investment in Peru's economy than there would be if the legal system functioned efficiently.

### **The inefficiency of the tax system**

When taxes are collected, the main burden rests on the relatively small group of people who are still operating formally, the state squanders vast resources on detecting evasion, and unnecessary distortions occur throughout the economy.

Businesses which are relatively large and therefore forced to operate formally pay more taxes than they would if informality did not exist, since the total tax burden is borne by a smaller tax base. This discourages many companies from expanding. In Peru, the development of industries which need to be large in order to operate and therefore cannot operate informally, is constrained. Second, tax evasion is so widespread that the state has to invest in a large number of costly strategies in order to detect evaders, who in turn expend resources on trying to avoid detection.

Let us pause for a moment to consider the unnecessary distortions in the tax system and in the economy in general. It is a well-known economic principle that any noncorrective tax is inefficient in some way. A tax on wages, for instance, may encourage people to work fewer hours. A tax on property makes property less desirable and encourages some businesses to use less land and invest in fewer buildings of their own. Taxes distort

economic choices, which is why one goal of the tax system should be to minimize these distortions, taking particular account of the costs of collecting and administering taxes.

One way to do this is to keep tax rates low. For example, a 90 percent tax on profits or earnings will prompt many people who might have been prepared to invest in some productive activity to do nothing instead. A tax of only 10 percent, on the other hand, might significantly reduce the distortion.

In Peru, where the government is so committed to satisfying needs by intervening directly and where there are few formals whom the system can tax in order to cover these costs, tax rates are increasing. Formal activity, in consequence, becomes less and less attractive and informality continues to grow. However, since the government persists in its efforts to obtain more revenue, it increases the taxes levied on formal activity and creates a vicious circle: increased informality, reduced formality, maintenance of the level of public spending, need to increase taxes on formal activity, greater incentives to operate informally, and so on.

### **Increased utility rates**

The same is true of public utility rates. It is estimated that almost half of Lima's water and electricity supply is unaccounted for. While there may be some leaks, most of these losses must be attributable to the informals, who tap the water and electricity supplies illegally. Most informals do not pay directly for these utilities, with the result that informality increases the rates for those who obey the law.

Again, much of formal activity is made up of businesses which remain formal only because they are too big or too well-known to desert to informality. Burdened by tremendous governmental requirements, they demand more and more privileges in return. Their poor performance and their need for privileges are consequences of the vicious circle we described above. We can see this even in formal export firms, which are taxed fairly heavily. Their disadvantage can be offset only if the Peruvian government reimburses, in the form of subsidies or subsidized interest, that part of their taxes which is attributable to a higher level of informality. (The situation is further complicated by the fact that such privileges violate international GATT agreements banning the subsidy of exports and provoke reprisals from importing countries in the form of antidumping laws or countervailing duties.) The net result is to raise the level of taxation of that part of

the formal sector which is not engaged in the export business and which will therefore shrink.

The distortion grows, then, as the circle continues. As tax rates increase, the inefficiency of the tax system becomes more marked. Taxes on employment discourage the recruitment of workers, added-value taxes discourage investment in formal production companies in general, and so on and so forth. According to the ILD's calculations, if this vicious circle continues and other conditions remain constant, informal production will account for 61.3 percent of the GDP recorded in the national accounts by the year 2000.

### **Limited technological progress**

The existence of informal activities undermines technological progress for a number of reasons, the main ones being the small size of the businesses, their lower level of interaction in production, and their inability to protect technological innovation.

We have seen that fear of detection, the absence of property rights, and the difficulty of enforcing contracts are all responsible for the small size of informal businesses. Although economists disagree about the size required for a business to make innovations, there can be no doubt that a relatively innovative business will be larger than informality would permit. We also know that one of the most usual ways of benefitting from an innovation is to increase sales. It makes no sense for a business which must avoid detection to increase its scale, however, for this would expose it.

Since innovative activity has positive consequences for the entire community, the losses resulting from its relative lack are borne not just by the businesses involved but by the entire country, which would otherwise be able to reap the benefits of technological progress.

### **Difficulties in formulating macroeconomic policy**

The macroeconomic decisions that a government makes—for instance, those relating to the size of the deficit or the rate of growth of the money supply—are largely determined by measurement of the performance of the economy. The existence of informal activities makes it extremely difficult to obtain precise information about national economic performance and introduces an excessive element of speculation into political decision making.

If informal activity were a constant proportion of total economic activity, the margin of error might not be so great. However, informal



activities, at least in some areas, have grown more rapidly than formal ones; as a result, their growth rate has been underestimated. The ILO found that Peru was 28.7 percent richer than the national accounts indicated in 1985. It is also likely that underemployment, unemployment, and inflation are overestimated, since some workplaces are not registered and the relatively low prices of informal transactions are not taken into account.

Although those in charge of macroeconomic policy are surely aware of the phenomenon, the fact is that the size and growth of informality make it more difficult to achieve an acceptable degree of accuracy in determining the level of economic activity and that they introduce a greater element of uncertainty into the task of designing macroeconomic policy.

## **The Law as a Determinant of Development**

So far, we have seen that Peruvians are forced to assume excessively high costs in order to operate legally or, if they are unable to do so, that they have been left out of the system. This means that they cannot take advantage of the country's good laws, namely the facilitating instruments provided by the law to make economic and social activities more efficient: property rights, contracts, and extracontractual law.

### **Facilitating instruments provided by the law**

The importance of property rights has been emphasized by various economic historians who believe that the boom in technological innovation in the West, and the massive investment that made it possible, began only at the end of the eighteenth century, when property rights were perfected and made independent of politics. Douglass North, for instance, provides copious evidence that the wave of major inventions in Europe began only when a system of patents was established to protect intellectual property rights. The importance of these patents resides in the fact that, with the exception of a handful of accidental discoveries, most innovation entails expensive research and education, costs which are worth assuming only if they can later be recouped. Before the Industrial Revolution, these costs outweighed the benefits later obtained. It was only when an ingenious legal instrument, exclusive patent rights, appeared that a legal basis emerged for defining intellectual property. This not only facilitated research for innovative purposes but also created a powerful incentive for

increased investment in education, research, and the search for innovative solutions to technological problems.<sup>5</sup>

Contrary to the belief widespread in Latin America, the economic importance of property rights is not that they provide assets which benefit their holders exclusively, but that they give their owners sufficient incentive to add value to their resources by investing, innovating, or pooling them productively for the prosperity and progress of the entire community.

The well-known example of the lake with vast reserves of fish illustrates this idea. If no one owns the lake, only its value as a source of food will be used, not its value as a hatchery. There will be no reason for fishers to limit their catch unless they can be sure that any fish they do not catch will not be caught by others and that, in the long run, once the fish have reproduced, they themselves will be able to benefit from their earlier sacrifice. The most likely outcome is that the reserves of fish will soon disappear. On the other hand, if someone had property rights to the lake, the owner would calculate its value both as a source of food and as a hatchery, because of the knowledge that the fish not caught today would reproduce and that many more could be caught tomorrow. It is the owner's profit motive which leads to the conservation and, thus, the maximization of the value of the fish reserves. The potential commercial benefits are the main incentive for making the necessary investment and trying to predict the economic trends that will determine the relative value of the resource. Naturally, the rest of society is also interested in seeing that this process of prediction and investment is carried out properly so that there will be no shortage of fish tomorrow.

This example is applicable, *mutatis mutandis*, to any resource to which property rights have not been granted, for instance, state wasteland on the outskirts of cities which can be used for both social purposes (housing) and economic purposes (workshops, factories, commercial businesses). Land, street, and route invasions have, in some ways, been the spontaneous means used by informals to create extralegal property rights in the absence of a good law. If the extralegal system did not generate these rights, there would be no incentive for the informals to develop and give economic and social value to these resources.

In tracing the history of contracts, Douglass North and Robert Paul Thomas point out in their masterful book that the Industrial Revolution in Europe was made possible by the fact that states substantially improved

<sup>5</sup> Douglass North, *Estructura y Cambio en la Historia Económica* (Madrid: Alianza Editorial, 1985).

compliance with contracts and significantly reduced the private costs of executing them.<sup>6</sup> The contract system was not created by the state, however. What happened was simply that, over the years, the authorities gradually came to recognize that the private sector's customary trade practices, many of them informal, were efficient and well established, and gave them force of law so that any breach of the terms of a contract could be prosecuted and penalized. As we shall see in the conclusion of this book, this procedure is extremely efficient since, instead of trying to shape reality to its wishes, the state converted into legal norms practices which had proved their feasibility. That feasibility had been partly established by the gradual emergence, in Europe's main cities, of public notaries who specialized in witnessing and registering contracts and mediating trade disputes, ensuring that agreements between producers and merchants were executed more efficiently. They also helped facilitate negotiations by establishing fixed rules and models which were used to adapt contracts to a variety of transactions.

The outcome of all this is that today, among formals and above all in the developed Western countries, where there is no need to avoid detection by the authorities, the confidence created by enforceable contracts makes people more prepared to take risks and these contracts have become requisite for long-term investments. Since innovation is the riskiest investment, if a government cannot give its citizens secure property rights and efficient means of organizing and transferring them—namely contracts—it is denying them one of the main incentives for modernizing and developing their operations. This is precisely what happens to the informals.

The developed countries' capital markets could also not have functioned as efficiently as they did if the state had not been prepared to require by law that instruments of credit be honored. Over the years, law courts began to recognize bills of exchange, promissory notes, and letters of credit. When the legislators agreed that such instruments could be made out to the bearer and not necessarily to a specific person, the innovation streamlined financial operations, for it enabled a lender or creditor to transfer assets to a third party and thus give economic agents a further mechanism for making payments and granting credits. This made it possible to engage in transactions taking place on two separate dates: that of the delivery of the merchandise or loan and, later, that of

<sup>6</sup> Douglass C. North and Robert Paul Thomas, *The Rise of the Western World* (London: Cambridge University Press, 1973).

payment or reimbursement. And as the legal security of transactions increased, so too did the volume of trade, the possibilities of financing production and innovation, and the access of new people to productive activities.

In other words, the modernization of the market economies which required that production and labor become more specialized and transactions more sophisticated, came about because the law made it possible to reduce the costs of a transaction. The aforesaid costs include all those which, independently of the transaction itself, are needed to conclude that transaction, namely, the costs of negotiating or executing contracts, providing and transferring property, transferring capital, recruiting labor, and distributing or insuring against risks—but above all, the costs of entering, remaining in, or remaining outside the legal system. The evidence presented throughout this chapter is that, in Peru, the costs of transaction, for formals and informals alike, are excessively and absurdly high, resulting in a tremendous waste of resources which can be halted only if the legal system begins to lower these costs efficiently.

It is clear that the absence of a properly understood and applied set of extracontractual laws, combined with the lack of property rights and contracts, is partly to blame for the fact that the damage done by the informal activities of Peruvians is not shouldered by those responsible for it but by third parties. This anomaly, which reduces the social value of those activities, can be corrected if extracontractual liability, the third pillar of any good legal system, is enforced.

Basically, what property rights, contracts, and extracontractual liability do is reduce uncertainty for people who want to invest their labor or capital in the development of existing resources. It would be hard to think of anything which discourages investment as much as uncertainty. No resident of an informal settlement will invest much in a home if there is no secure ownership of it, no street vendor is going to improve the environment if eviction is feared, and no minibuses operator will respect public order on a route to which rights are not recognized. The people we interviewed feel there is a constant risk that the law will be forcefully used against them and that their activities will be abruptly interrupted. It should be pointed out that the costs of informality also affect formals and particularly increase the uncertainty of the costs of remaining formal, for there is no property right, contract, or extracontractual liability which can be regarded as constant when the state can use the legal system arbitrarily.

We might gain a better understanding of the uncertainty created by the absence of facilitating legal instruments by relating it to the function of

insurance. Let us suppose that, each year, there is one possibility in a thousand that a motorcar valued at \$10,000 will be stolen. The hypothetical annual cost of a theft would be \$10, or one-thousandth of the \$10,000. If the owner of this car does not care about the risk, it will not matter whether the car is insured, at a cost of \$10 a year, or that there is one chance in a thousand of losing it, a cost of \$10,000. The fact is, however, that few people are indifferent to this risk. Most people, if they have the means, will pay far more than \$10 to offset the possible loss. The widespread purchase of insurance, throughout the world, shows that people do not like uncertainty and are prepared to pay a high price to avoid it. The uncertainty which the law does not undertake to dispel discourages effort and encourages people to find other ways of reducing their risks.

Formals reduce their risks in different ways—by distributing shares and liability among business partners, diversifying their commercial portfolio, establishing precise limits to their liability, and buying insurance policies. They may also reduce their risks by connivance and by the constant use of intermediaries to gain official protection against unforeseen events. Generally speaking, none of these methods of reducing uncertainty is accessible to informals, with the exception of small-scale diversification and a certain capacity for political negotiation won by some of their unions. They try to reduce it by other means which, as we have seen, include paying bribes, minimizing investment, overinvesting in movable assets, diversifying or decentralizing production, or trading with and employing mainly relatives, friends, or people they know from the same region. In particular, the payment of bribes, which among the informals we interviewed came to between 10 and 15 percent of their gross earnings, is indicative of the fear created by uncertainty.

If they were given property rights and could be sure that their contracts were enforceable, and if extracontractual liability were adjudicated efficiently, this uncertainty would be reduced and the value of informal economic activity would increase systematically. Greater certainty would increase the value of both the labor and the capital of the nation. In any country, uncertainty or legal instability reduces the volume of long-term investment and investment in plant and equipment. People save less and invest the little they do save in such socially unproductive goods as jewelry, gold, or luxury property. The flight of capital from countries like Peru is only one more result of the desire to avoid uncertainty.

Of course, not all uncertainty can be eliminated, but there are certain types of uncertainty which are completely unnecessary, for instance, those suffered by informals because they lack facilitating legal instruments. An

appropriate change in the requirements of the law to make such instruments universally available would immediately reduce the amount of uncertainty.

## Incentives, specialization, and interdependence

We have spoken of good laws and bad laws, a good law being one that guarantees and facilitates the efficiency of the economic and social activities it regulates and a bad law, one that disrupts or totally prevents it. Using the term as we have throughout this chapter, we can say that Peruvian laws are predominantly bad because those who drafted them did not take into account their costs and the way in which they stifled economic activity. The most tangible proof of the unsuitability of these laws is that the vast majority of the economically active population has chosen to operate informally and a minority have chosen to take their professional expertise and their capital elsewhere. In other words, they have chosen to operate outside these bad laws, which entail such high costs and such complex regulations.

It is not enough that a good law be neutral and not encourage people to operate informally. It must also do at least two other things: it must create incentives for people to seize the economic and social opportunities offered by the country; secondly, it must facilitate the specialization and interdependence of individuals and resources.

Let us first show why incentives are important. As we saw earlier, the urban economy increases the opportunity to earn more but, in order to do so, it is essential to increase the value of the opportunities perceived. However, the value of these opportunities is determined by the legal system. For example, a maze of red tape must be negotiated in order to use waste land legally. The economic value of the land is directly affected by the cost of complying with the red tape. If a house is built on the land, its value will be determined by the extent to which one can be sure that third parties will not take it over, either violently, through invasion or vandalism, or through more subtle encroachment such as the restrictions which the state may impose on the use or transfer of property. In other words, the land may be the basis for a house, but its value and its development will decrease as the difficulties of obtaining it by adjudication, making it secure, confirming title to it, and selling or renting it increase.

Thus, the actual value of an economic opportunity is not the value it would have if it could be realized without cost, but rather its estimated

value, taking into account the cost of the red tape, the degree to which it can be protected against third-party appropriation, and the ease with which it can be sold. The less costly the transaction and the more secure the right to enjoy the fruits of investment, the greater the real value of an economic activity. A law that is efficient in dealing with these elements will encourage people to identify and seize existing opportunities and will systematically increase the value of economic activity.

Second, a good law must also encourage the specialization and interdependence of individuals and resources. In any society, certain individuals are better equipped than others to perform specific productive tasks. Similarly, certain material resources are more productive if they are used for some purposes than for others. It is an economic maxim that if, instead of trying to meet their needs directly, members of a society specialize in the tasks they are best able to perform and exchange among themselves the fruits of their labor, everyone will achieve a higher level of well-being. Specialization of material resources also increases well-being because their social benefit is maximized if they are used for purposes which increase their value for all parties and not just for those who possess them.

In order for the members and resources of a society to specialize, however, those investing the resources must be sure of a return on the investment. This will happen only if all the members are sure that the transaction will benefit them, that what they receive in exchange for their labor or products will bring them greater benefits than they could have obtained alone. This is why economists say that exchanging resources increases their value and, consequently, the well-being of all.

However, this specialization of individuals and resources cannot take place if individuals are isolated and do not trust one another. Isolation and mistrust rule out specialization because, by definition, specialized persons need others to supply their requirements. As a result, it becomes essential for producers to trust the system of exchange, which means that the system of exchange must be organized in such a way that it provides security to everybody. There can be no denying that the law, and the institutions safeguarding it, are the principal source of this trust.

The law, then, allows citizens to specialize because it enforces property rights, promotes reliable contracts which enable these rights to be organized and transferred, and attributes liability when it is not established by a contract. These three elements are essential if a society is to make the best use of its citizens' initiatives and labor and of its material resources. The main idea underlying this viewpoint is that, if the state provides good

laws, it makes specialization and exchanges far easier, enabling human and material resources to be used in the best possible way. An appropriate system of property rights, contracts, and extracontractual liability can spontaneously generate the efficient use of resources without a bureaucracy to decide or authorize how the resources must be used. Citizens dependent on this system will have sufficient incentives to produce, through a multiplicity of efforts and private transactions, an economic system which is exceptionally sensitive to the opportunities for development.

This is a crucial proposition, for traditional academic thinkers still believe that the causes of development are purely economic achievements—technological progress, accumulation of savings, investment in human capital, reduction of transport costs, economies of scale—when in fact these are not the initial causes. None of these alleged causes explains why, in some countries, people are more innovative, save more, are more productive, and are prepared to run greater economic risks. Are we inhabitants of underdeveloped countries genetically or culturally incapable of saving, innovating, taking risks, or running industries? Or are these “causes” of development not the causes at all, but in fact development itself? Is the real cause an official set of legal and administrative institutions which encourages technical progress, specialization, exchanges, and investment? The evidence gathered in this book points in the latter direction.

It is because of bad laws, then, that both formals and informals are only incipient, interdependent specialists whose potentialities will remain limited as long as the state fails to give them the incentives needed for progress, namely good laws.

### **Is the law the only determinant?**

So far we have analyzed the legal aspects of the problem of informality. We should now ask ourselves whether there are other aspects of the problem.

Peruvians in general, and informals in particular, have specific preferences, skills, and patterns of behavior which can be regarded as social, cultural, or ethnic factors that dictate the existence of informality. They also have preferences for specific goods and services, which can be regarded as economic factors. All of these elements certainly combine with the legal situation to influence, and even determine, the characteristics of informality. For instance, it may be more complicated and therefore more costly for a person from a rural society to comply with certain legal requirements than for a person who is accustomed to life in an urban



society. On the other hand, people who find the social, ethnic, or cultural characteristics of informals repugnant, will make a greater effort to enter and remain in formal activity than those who are attracted by or indifferent to these characteristics.

The problem is one of determining how much these factors contribute to the phenomenon, whether they are essential or secondary. Let us take the invasion of state waste land as an example. What explanation can we find for this phenomenon, if we view it from a cultural or social standpoint? Is it an age-old practice which reflects Peruvians' partiality for getting together and invading other people's property? Of course not.

From a legal standpoint, on the other hand, the explanation is perfectly clear. When it takes seven years and several thousand dollars to obtain land for housing, most people, regardless of their skills, education, and attitudes, will invade land and acquire it informally. If the red tape were reduced, there might still be people who would prefer to invade land and risk all the adverse consequences, but they would be a minority.

Let us view the problem from another standpoint. If the cultural differences between formals and informals are really so great, how are we to explain the fact that so many informals are ready to try to find a way of formalizing their activities and, moreover, that so many people operate both formally and informally at the same time? The ingenious, productive, and innovative way in which Peru's informals work, their determination to win legal recognition, the existence of an extralegal system of norms, and what they produce and consume seem to indicate that, from an economic and social standpoint, informals have very similar aspirations to formals. Although no one denies the relative importance of social, cultural, or ethnic factors, we simply have not found any evidence to bear out the theory that they explain why a large sector of the population operates outside the law.

The legal system so far seems to be the best explanation for the existence of informality. From this standpoint, the choice between working formally and informally is not the inevitable result of people's individual traits but, rather, of their rational evaluation of the relative costs and benefits of entering existing legal systems.

## **The law and national development**

All the evidence suggests that the legal system may be the main explanation for the difference in development that exists between the industrialized countries and those, like our own, which are not industrialized.

It sometimes seems as if experts in developed countries automatically assume that their legal institutions exist in every country. This is not the case, however. The debate about development will therefore have to be reformulated to take the importance of legal systems into account. We cannot continue to close our eyes to the fact that not all of a society's decisions are determined by its cultural characteristics or economic systems.

How many investments could people in the United States and Western Europe have made without clearly defined and secure property rights, a system of extracontractual civil liability, and a system of justice which protected their property? How many innovations would they have made without patents or royalties? How many assets, long-term projects, and incentives for investment would they have managed to create without enforceable contracts? How many risks would they have run without limited liability systems and insurance policies? How much capital would they have accumulated without enforceable guarantees? How many resources would they have been able to pool without legally recognized business organizations? How often would they have gone bankrupt and had to start all over again if they had not been able to convert their debts into shares? How many businesses and private institutions would have survived for generations without hereditary succession? Would they have been able to industrialize without economies of scale? We sincerely believe that development is possible only if efficient legal institutions are available to all citizens. This belief is strengthened when we consider that, despite the informals' efforts and sacrifice, informality is characterized essentially by the absence of such institutions.

However, we do not seek to underestimate the importance of the country's cultural identity. The way in which Peruvians use their economic opportunities and demonstrate their preferences for certain goods and services rather than others reflects the country's culture and ideology. Certainly, the Japanese, for all the far-reaching recent technological and economic changes in their country, also continue to be culturally identifiable. As we have seen, Peru's traditional customs, its regard for reputation, family ties, communal activities, and concepts of hierarchy and status are put to imaginative use by the informals. There is no reason, after an appropriate reorganization of the country's legal institutions, that the rest of the country's social mechanisms should not continue to be influenced by Peru's cultural heritage.

This heritage will, in turn, always determine the nature of our development and the range of creative possibilities offered by it. How many of these possibilities can actually be realized and how many Peruvians will

be able to benefit from them will, however, depend primarily on the country's legal institutions.

It is simpler and cheaper to bring the formals and informals together by changing the law than by trying to change the characteristics of the people. To show the informals how the existing laws operate, or to try to convince them that they will increase their social standing by accepting the mercantilist system inherited from Spain, would be to alter their culture drastically. It makes more sense to adapt the law to reality than to try to change everyone's attitudes, for the law is the most useful and deliberate instrument of change available to people.