Regulatory Reform in Peru

Peter H. Schuck and Robert E. Litan

REGULATORY REFORM is largely unknown in Third World nations. Yet it is in these countries that the consequences of excessive or inappropriate government regulation are most tragically illustrated. Poverty, corruption, and violence—aspects of everyday life in the Third World—reflect deeply flawed political and legal institutions.

In Peru today, the economy has split in two. Roughly half of the population lives and works in a "formal sector," with its activities officially sanctioned and protected by the formal legal system; the other half pursues most of its personal and commercial activities in the "informal sector," outside the reach of government and the law. In areas as diverse as housing, retailing, and transportation, the informal sector competes with, and in some cases completely dwarfs, the formal sector. The booming informal sector is, at once, a testament to the vital entrepreneurial spirit in the country and a reflection of fundamental flaws in Peruvian institutions.

Remarkably, there is a movement underway to reform the rulemaking processes in Peru. Initiated in 1982 by Hernando De Soto, a native businessman, the reform movement is premised on the insights of "law and economics," as developed principally by American scholars. This article recounts De Soto's regulatory reform saga and the powerful ideas that lie behind it.

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Discovering the Informal Sector

Hernando De Soto is a successful Peruvian businessman who once held a seat on the governing board of Peru's central bank. A member of a prominent diplomatic family, he was educated in both Peru and Europe, and spent roughly a decade working abroad, first in the Secretariat of the General Agreement on Tariffs and Trade and then in the European private sector. De Soto returned to Peru in the late 1970s.

Peru was in turmoil when De Soto returned. Under the leadership of President Fernando Belaunde Terry, civilian rule was being restored after 12 years of military dictatorship. Half of the population was unemployed or underemployed. The situation was particularly chaotic in the capital city of Lima, where two-thirds of the population had come to reside. Between 1965 and 1980, the population had doubled in size, from 2.3 million to 4.5 million people. This explosion was due largely to a mass migration of Indians from ancient villages in the Andes to the dusty plain in which Lima is situated. The new arrivals "invaded" the barren, unoccupied, government-owned land at the outskirts of the city, and built crude dwellings that were often no more than cardboard shacks.

While others were complaining about the invasions, De Soto was noting something of interest. Within a relatively short period of time, the illegal, jerry-built houses in the squatters' areas (known as *pueblos jovenes*) often flourished. Amid the general disorder and destitution, enclaves emerged where one could see permanent housing, urban infrastructures, and neighborhood amenities. De Soto was also fascinated by the myriad of street vendors that lined the city's streets. Known as *ambulantes* because of the mobility of their bicycle- or hand-pulled merchandise carts, these vendors sold food, clothing, and a wide variety of other goods—and did so without the municipal licenses required by law. They reappeared daily at the same locations, seldom quarreled with their fellow vendors about who could sell what and where, and were rarely disturbed by the police.

De Soto coined a term for these illegal but open activities: "informality" or the "informal sector." The term contrasts these activities with those conducted under the authority of Peru's formal legal system, which defines and protects recognized property rights, governs legitimate commercial conduct, and adjudicates disputes.

Fascinated by these economic arrangements, De Soto decided to learn more. In 1982, with the encouragement of some prominent Peruvians—including Richard Webb, the director of Peru's central bank, and Mario Vargas Llosa, one of the nation's most celebrated authors—he established a research and advocacy organization, the Institute for Liberty and Democracy. Funds were raised for the new institute through a series of international conferences. Participating in these conferences were such leading figures as economists Friedrich von Hayek and Milton Friedman, and Secretary General of the United Nations Javier Perez de Cuellar, along with aides to Belaunde, and representatives of the Peruvian Communist party.

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A small group of energetic young lawyers and economists was organized to staff the institute. Their first task was to assemble basic information on the nature and extent of informal activity in Lima. Their second task was to begin educating Peru (and other South American countries) about the importance of the informal sector to the nation's economic life. They did this by generating a torrent of reports, news articles and television appearances.

What was learned about the informal sector was astonishing. Over half of the population of Peru conducts most of its personal and commercial affairs in the informal sector. In addition, sophisticated modes of organization have emerged in the informal sector to replace the legal rules that govern the lives and activities of people in the formal sector.

Housing. Informal housing is typically undertaken by well-organized groups of as many as 20,000 people. The sheer size of these groups—consisting of both potential voters and, if evicted, potential rioters—ensures they cannot be ousted by the formal authorities or by competing groups of residents. Invasions are coordinated by professional promoters who specialize in securing municipal services and negotiating with political leaders and the police. Within hours after an invasion begins, the new residents draw boundary lines to mark off individual plots, and these are enforced by the group in the event of disputes. Over time, the wooden structures that populate the *pueblos jovenos* are gradually improved with bricks, gardens, sidings, second stories, and even roofs (a luxury since it last rained in Lima in the early 1970s). According to the institute, 47 percent of Lima's citizens currently live in informal housing; an estimated $8 billion has already been invested in these (illegal) residences.

Transportation. Informality is even more widespread in the urban transportation sector, particularly Lima's municipal bus system. It is estimated that almost 9 out of every 10 passengers ride on buses that are operated either by "semi-formal" drivers—who have bus routes granted under a municipal franchise and charge regulated fares, but who generally do not report their incomes to the tax authorities—or by purely informal drivers—who operate without a franchise and charge what the traffic will bear. In an otherwise highly regulated city, a market has developed in which bus routes are effectively traded and enforced through means other than the formal law. Judging by the business they generate, informal drivers provide a service far more highly-valued than the formal bus system.

Commerce. Informality also dominates the activities of small commercial entrepreneurs, particularly the *ambulantes.* Estimated to number 84,000, *ambulantes* offer a full menu of perishable and durable goods for sale in competition with larger legal establishments. Despite their informal status, the *ambulantes* are highly organized. Street vendor organizations assign and enforce "property rights" to slices of sidewalks that have estimated property values averaging $500-$750 (comparable to several months' earnings). Dues are collected, and are used to help finance the construction of local markets. Since 1970, more than 270 informal markets have been constructed in Lima. In contrast, just 57 local markets have been built by the municipal government during that time.

Informality in Peru's industrial sector is not yet well documented, but there is little question that it exists. According to the institute, numerous small manufacturing enterprises—textile facilities, repair shops and the like—are operating informally in the urban areas of Peru. To avoid detection, these enterprises are kept small, generally with fewer than a dozen employees, and are operated in hidden locations.

The Cost of Informality

Although individuals in the informal sector have benefited from their ingenuity in circumventing the law, Peruvian society as a whole has suffered from the pervasiveness of informal arrangements and the conditions producing those arrangements. Measured in terms of foregone opportunities, the social and economic costs are substantial. Informal firms, because they operate illegally and in remote areas, cannot obtain formal bank financing nor can they fully exploit economies of scale, advanced technologies, or access to markets. Incentives to save and invest are weakened by the absence of legally-protected property and contract rights. And the bribes that must be paid to avoid detection waste scarce resources and result in a perverse redistribution of income from generally poor individuals to police and other better-off officials.

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Widespread informal activity carries a heavy political cost too. Informality on the scale found in Peru, and the bribery and cynicism so essential to its maintenance, create an environment in which *all* laws come to be seen as impediments to individual economic advancement. In a society in which self-government and democracy are in their infancy and terrorism is an almost daily occurrence, respect for legal institutions is a precious, limited resource not to be squandered.

In Search of an Explanation

De Soto was well aware that neither the formal sector nor the informal sector was operating as efficiently as it could be. Peru's limited resources were being wasted. But how had the legal system contributed to this state of affairs?

To find an answer to this question, De Soto immersed himself in the study of law and economics. He familiarized himself with academic research on the economic effects of legal rules, the ways in which a redefinition of property rights can enhance economic efficiency and protect individual liberty, and the value of cost-benefit analysis.

Stimulated by his reading, he came to the United States in 1983 in search of scholars and practitioners who could educate him and the institute staff, and assist them in applying the insights of law and economics theory. De Soto's first American contact was Judge Robert Bork, who referred him to Professor Warren Schwartz (Georgetown University Law School). The two authors became involved in the institute's work through Professor Schwartz. Many others have also become involved, including Stuart Butler (Heritage Foundation), Robert Crandall (Brookings Institution), Saul Levmore (University of Virginia Law School), Peter Huber (Washington-based attorney and scientist), Michael Block (Arizona State University), Jerry Mashaw (Yale Law School), Gordon Tullock (George Mason University) and Lawrence White (formerly of New York University and currently a member of the Federal Home Loan Bank Board).

Regulatory Overkill

With the assistance of these scholars, the institute began to integrate and interpret the fragments of data into a meaningful view of the Peruvian economy. The explosive growth of the pueblos jovenes in Lima, for example, was found to be a response to a severe housing shortage caused by a byzantine regulatory system for securing legal title to unoccupied land. New arrivals wanting to acquire land had to negotiate a bureaucratic process consisting of more than 200 stages and taking a minimum of seven years.

Bureaucratic lethargy and red tape were identified as causes of much of the informal activity in the area of commerce as well. When the institute attempted to test the responsiveness of the regulatory system by forming a small manufacturing business, it took 289 days to obtain all the necessary government approvals and licenses for getting started. Rigid labor laws have provided some of the incentive for businesses to operate outside the law. As in many other countries, formal establishments in Peru find it virtually impossible to fire incompetent or malingering employees, and Peruvian corporations have long been required to share a portion of their profits with their workers.

Informal arrangements in Lima's bus system were also found to be caused by regulatory overkill. By keeping regulated bus fares extremely low—less than 10 cents per ride despite fuel costs that are equivalent to, or even higher than, in the United States—the city has encouraged drivers of roughly half of all daily traffic to deviate sharply from their franchised routes to pick up passengers wherever they can find them, sacrificing service to augment volume. These buses are crowded and their routes labyrinthine. Another class of informal buses, which carries much of the rest of municipal traffic, offers more direct service under more comfortable conditions, but charges higher (unregulated) prices.

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Finally, informal credit arrangements were found to be caused by government regulation. A tight system of interest-rate controls has enabled eligible borrowers to obtain financing at negative real rates of interest and forced formal credit institutions, such as banks and savings associations, to ration credit. Not surprisingly, this rationing system has rewarded firms and individuals in the formal sector. Potential borrowers in the informal sector generally lack the income or credentials necessary to use banks. Due to their illegal status, they typically lack enforceable property rights in merchandise and housing that could serve as collateral.

Peruvian-Style Mercantilism

Contemporary Peru, the researchers concluded, had adopted a "mercantilist" political economy. Large corporations, engaged in classic anti-competitive, rent-seeking strategies, had developed a symbiotic relationship with the national government which was willing to secure rents for its corporate allies through the exercise of its regulatory authority. This conception of Peruvian mercantilism conjured an image familiar to

American scholars of public choice and law and economics. The practice of mercantilism, yoked to the popular ideology of socialism in a society that had never developed strong defenders of competitive markets, reinforced a dismal economic and political status quo. It had succeeded in bringing the Peruvian economy to its knees and choking off prospects for any significant change.

To bring about genuine reform, it would clearly not be enough to attack this or that anticompetitive regulation. The underlying institutional and ideological foundations that supported mercantilist regulation had to be challenged so that competitive enterprise could flourish under the protection, rather than the threat, of the formal law. A "law and order" approach emphasizing more effective enforcement of regulations in the informal sector did not make sense either. Such an approach was utterly impractical in a country like Peru where bribery is a way of life and the income generated from it is expected to supplement meager official salaries. Indeed, a law and order strategy, by increasing the demand for (and thus the cost of) bribes, could aggravate the perverse consequences of the existing system.

De Soto settled on the idea that administrative rights (i.e., governmentally conditioned, highly restricted licenses to do business) should be replaced with property rights. The latter would be designed to facilitate economically beneficial transactions by expanding and protecting the right to compete. In some cases (such as price controls on selected commodities), a property rights strategy could imply the complete deregulation of particular markets. In other cases (such as food safety), it implied a relaxation or redesign of controls.

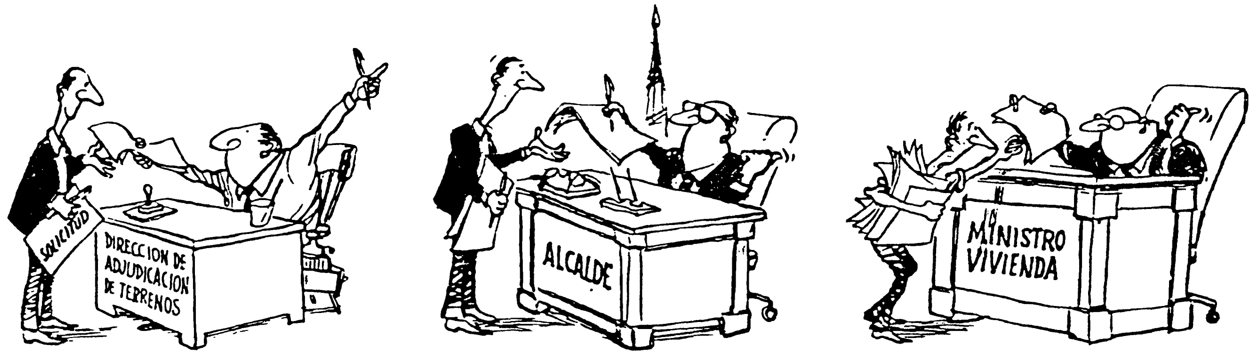
Unfortunately, no real political constituency for regulatory reform existed in Peru, and the institute was not in a position at that time to make a definitive case for deregulating any one sector. Therefore, De Soto deferred proposals for substantive regulatory reform of particular markets, and sought instead to establish procedural reforms that could be applied across-the-board to all regulations.

Rulemaking in Peru

Compared with the American rulemaking process, with all its due process guarantees, rulemaking in Peru is a remarkably straightforward process: a ministry wishing to adopt a rule simply publishes it in final form in *El Peruano*, the official government newspaper. Private individuals have no legal right to participate in the process, and there are no sanctions, judicial or otherwise, for illegal rules or procedures. The government employs few economists or policy analysts, and almost none who are highly-trained (by American standards) in the art and science of regulatory impact analysis. The ministries control what little information is gathered, and jealously guard the public's access to it. By and large, the groups that stand to gain from regulatory analysis—informal entrepreneurs burdened by mercantilist regulations—are unorganized, unsophisticated about such matters, and reluctant to become too visible lest they be harassed by the police.

Reforming Administrative Procedures

De Soto offered his proposed overhaul of Peru's rulemaking process in November 1984. Modeled after the American procedures for public notice and regulatory analysis, it required that all regulatory proposals that could affect "the incorpora-



tion of the informal sector into the legal system or the maintenance of the formal sector therein" be published along with brief justifications; that opportunities be given to interested individuals or groups to submit their views; and that the ministries take public comments into account in drafting final rules. In addition, the National Committee on Economic Rights, established (at De Soto's urging) to defend the interests of the informal sector, was given a key role in defining the details of the rulemaking process. Remarkably, Belaunde adopted this proposal in the form of a Supreme Decree.

One of the authors of this article (Schuck) drafted the contents of the National Committee's recommendations and prepared the necessary supporting materials. These recommendations, after review by the Council of Ministers, were incorporated in another Supreme Decree. After briefings from administrative lawyers from the National Committee and the institute about the Peruvian regulatory structure, a series of documents was drafted that was intended to comprise a general legal framework for regulatory reform. This framework consisted of four major elements: (1) a procedure for rulemaking, essentially drawn from the U.S. Administrative Procedure Act; (2) a procedure for regulatory impact analysis, modeled on President Reagan's 1981 Executive Order 12291; (3) a manual to assist the ministries in the preparation of regulatory analyses; and (4) a proposal to transform the Office of the Public Minister, statutorily designated "defender of the people," into a kind of governmental ombudsman—advocate for the informal sector, and expert commentator on regulatory proposals. These recommendations were reviewed by De Soto and the institute staff in a process that the participants came to call "Peruvianization"—the documents were translated into legal Spanish and, more importantly, the procedural requirements imposed on the ministries were simplified.

The centerpiece of this package of reforms was a requirement that each ministry wishing to propose a regulation publish, for public comment, a regulatory analysis (known as an "ABIP," its acronym in Spanish). The other coauthor of this article (Litan) helped to prepare several model analyses, which were circulated among the ministries to demonstrate the feasibility and value of the technique.

To our knowledge, no other developing country has adopted a comparable package of reforms. In a state that churned out new regulations mindlessly or anti-competitively—but in either case without significant constraint—these new legal structures promised to democratize and rationalize regulatory intervention. For the first time, mechanisms had been created to bring to the foreground the interests of the informal sector and small-scale enterprise. The new procedures were in some ways even more ambitious than those adopted in the United States. (For example, cost-benefit analyses were required of virtually *all* rules affecting the private sector, not just major rules.) If nothing else, the new process might slow the regulatory juggernaut.

The problem, as it turned out, was in implementation. A presidential election (the first since 1980) was held in the spring of 1985 and Belaunde and the Popular Action party were defeated by Alan Garcia and the American Popular Revolutionary Alliance in an overwhelming vote. Kept out of power for more than a half-century by force and fraud, the APRA could hardly be counted upon to retain, much less implement, a politically controversial regulatory reform program endorsed by a discredited, outgoing administration.

In the end, neither the Peruvian government nor the bureaucracy was prepared to accept

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such a significant change in the legal landscape without a struggle. A few regulators complied with the decree, but most balked and then simply refused to cooperate, confident that the interests of Belaunde's successor lay elsewhere.

A Second Try at Reform

The regulatory reform story in Peru could have ended at this point. That it did not was due to a switch in strategy by the institute—away from working through the government to "going public" with a media campaign.

The new strategy emerged two weeks after the national elections when a decree was issued by the municipality of Lima imposing a tight system of regulation on street vendors. The institute prepared its own regulatory analysis of the new rule and published it as a full-page advertisement in all of the city's major newspapers. The advertisement pointed out how the costs of the street vendor regulation far outweighed its benefits, that it would only aggravate the problem of bribery, and that it would result in increased consumer prices for the vendors' products.

The response was immediate. Organizations of street vendors protested the new rule. Several of the city newspapers criticized the rule in their editorials. Newspapers, magazines, and television continued to report the controversy, building pressure on the municipality to reconsider its regulatory decisions—something that was previously unknown in Peru.

Later in the year, the institute mobilized the municipal bus drivers union in Lima against a proposal to use bus drivers as tax collectors in a new transportation tax system. Although the proposal was eventually implemented, the institute attracted considerable notice and generated support for its activities among a large organized work force. By this time, *Caretas*, a major Peruvian weekly magazine, had begun publishing articles prepared by the institute on the relationship between regulation and the informal sector.

More success followed in the spring of 1986 when the institute persuaded the Garcia government to direct the Public Minister to exercise his "defender of the people" responsibilities. The institute then helped orchestrate a flood of complaints from groups representing over 300,000 residents of informal housing about their difficulties in securing title to their make-shift residences. The institute cited these complaints in urging the government to grant title in an orderly fashion and to streamline the bureaucratic hurdles involved.

The housing reform campaign struck a strong political chord. With the prospect of granting title to millions of Peruvians, President Garcia quickly seized the issue and attempted to make it his own. In April, 1986, he made a well-publicized trip to the *pueblos jovenos* where he announced a titling law that was immediately approved by the lower house of Peru's legislature.

Presently, the institute is continuing its efforts to demonstrate to the government, the informals, and the general population, the perverse effects of excessive regulation. A major book by De Soto has been released and it is gaining widespread circulation, especially in the informal sector. Efforts are being made to convince the informals that they have a strong common interest in combating excessive regulation through political action. It is hoped that a constituency of informals, once assembled and mobilized, may succeed in motivating Peru's leaders to adopt legal reforms. To date, however, the provisions of the Supreme Decree remain largely unenforced.

Some Hard Lessons

There are several lessons to be learned from Peru's experiences. First, there are important—and in many quarters unrecognized—links between informal activity, economic growth, regulatory rationality and accountability, and the legal system. For Peru to achieve its potential, it must have a legal system with well-defined and enforced property rights. This, in turn, will necessitate ideological and institutional commitments that Peru has been manifestly unwilling to make. Unless the government is prepared to alter the underlying "rules of the game," significant improvement in Peru's long-term economic performance is unlikely.

A second lesson is that a tight and pervasive regulatory regime can not wholly eliminate productive economic endeavors. Despite the hazards, millions of Peruvians are organizing their own sets of rules to facilitate mutually beneficial exchange. That result, by itself, should indicate to government leaders the limits of regulation.

A third lesson pertains to the danger of what one might call "intellectual imperialism"—the tendency of reformers to underestimate the significance of their value assumptions and policy goals, and to neglect the cultural, institutional and political obstacles to implementation. The many discussions about "Peruvianization" were intended to avoid the most serious risks of ethnocentric distortion, but, with limited time, we never succeeded in wholly shedding our premises or in fully understanding theirs. Our frantic search for mechanisms to enforce the proposed reforms—courts, media, public interest groups, individualistic ethos, ombudsmen, *anything!!*—was resourceful, but in the Peruvian context largely irrelevant.

A fourth, perhaps more obvious lesson is that achieving fundamental reform in a Third World political economy is an exceedingly difficult, laborious process. Policy innovations must be sponsored at the apex of government to ensure their placement high on the public agenda. At the same time, broad coalitions must be formed and mobilized. De Soto did not fully appreciate soon enough that even when new policies are endorsed by power holders, they may flounder if pushed too fast—or only from the center. And yet, in the politics of Third-World economic reform, timing is critical. Had De Soto and the institute started their work several years earlier, had the new Garcia regime been less determined to uproot what its predecessors had cultivated, had Peru's political and economic conditions been somewhat less turbulent, regulatory reform may well have become a reality.

While it would be gratifying to conclude this account by saying that the prospects for regulatory reform in Peru remain bright, we do not believe this is the case. Five years after the crusade for regulatory reform began, the institutional obstacles to reform loom as large as ever. At least there is comfort to be drawn from the institute's continuing efforts to surmount the obstacles. □

Selected Reading

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