The (Underground) Wealth of Nations

An economist compares black markets in the West, the Eastern bloc, and the Third World.

BY EDGAR L. FEIGE

Mario Vargas Llosa's foreword to *The Other Path* accurately divines that "Economists occasionally tell better stories than novelists." But are novelists to be trusted to evaluate the state of the art in economic research? Vargas Llosa identifies the protagonist of Hernando de Soto's "story" as "a hitherto little studied and even less understood phenomenon—the informal economy." In fact, the informal or underground economy has been intensively studied for two decades. It is the subject of dozens of books and hundreds of scholarly articles, and has received the attention of congressional committees, the Agency for International Development, the Internal Revenue Service, the UN's International Labor Organization, the Federal Reserve, and the International Bank for Reconstruction and Development, among others. These intellectual antecedents suggest that there is much we already know about informed economies, yet the novelty of de Soto's conceptual and empirical work makes clear that there is much we still have to learn.

The Other Path examines the historical, institutional, legal, and economic factors that account for the stagnation and paralysis of the development process in Peru. The villain of de Soto's story is Peru's mercantilist state, which mirrors "the European mercantilism of earlier centuries" that had been attacked by such unlikely bedfellows as Adam Smith and Karl Marx. It is a system "more concerned with transferring wealth" [among its elite adherents] than with laying the institutional bases for creating it.

The hero of de Soto's tale is the informal economy, the collection of street vendors, builders, manufacturers, and transporters who employ illegal means (land seizures, illegal purchases, tax evasion, and operating without permits or licenses) to pursue the legitimate objectives of producing and distributing goods and services to earn a livelihood. Because members of the informal economy are systematically excluded by the state from the normal protection of contract enforcement, tort law, and property rights, their illegal actions represent a rational response to the constraints and high transaction costs imposed upon them by a suffocating state bureaucracy.

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This underground economy, being large, economically efficient, and democratically organized, represents the political constituency that de Soto believes will bring about the radical institutional changes required for the development process to go forward. Although *The Other Path* often reads like scientific economics or history, it is, according to its author, "a political book . . . which seeks to offer guidance and, above all, to show that there is hope amidst all the apparent disaster."

As a political story, *The Other Path* presents a novel and subversive plot with important economic overtones. For de Soto, the promise for Peru's future lies neither with the left-wing revolutionary group the Shining Path (Sendero Luminoso) nor with the right-wing statist oligarchy. Rather, it resides with the participants in the underground economy. They, according to de Soto's estimates, constitute almost half the economically active population and contribute close to 40 percent of the gross domestic product.

This vast informal sector of economic activity is viewed not as the source of Peru's economic paralysis, but rather as the solution to its difficulties. This formulation of the promise for development has a unique appeal to those who harbor a genuine concern for the poor yet cherish the market-oriented institutions that promote economic freedom. How well the structural consistency of this agenda for development will withstand the close technical analysis of social scientists and policymakers is too early to predict.

The Other Path has already been a lightning rod for controversy, and its argument will surely attract further scrutiny. For despite the fact that the underground economy has been actively researched for some time, its precise function in the development process is still far from being well understood. Because the underground appears as a major character in a broad variety of economic and political contexts, a brief overview of its role in various settings might help to illuminate both the problems and promises inherent in de Soto's work.

What is this phenomenon popularly known by the catchphrase the "underground economy"? There is, in fact, no single underground economy—there are many. These underground economies are omnipresent, existing in market-oriented as well as in centrally planned nations, be they developed or developing. Underground economies have been variously characterized as illegal, subterranean, hidden, gray, black, unreported, unrecorded, unenumerated, parallel, second, shadow, irregular, casual, and informal. The plethora of nomenclature illustrates the problem of usefully defining the phenomenon in question and accurately measuring its scope.

What the foregoing descriptions have in common is the recognition that those who engage in underground activities often have a penchant for secrecy, which makes these economies so difficult to study systematically. Yet their apparent ubiquity motivates social scientists and policymakers to learn more about them. Major efforts have been undertaken to differentiate between various types of underground economies, develop a nomenclature to identify them, and create operational methods for estimating their size and composition. Satisfactory definitions and methods of measurement are necessary to determine the causes for their growth and to analyze their implications for a broad range of pressing economic, social, and political issues.

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The Western world's underground economies

In the developed nations of the West, underground economies are typically identified with a variety of serious problems. They have been linked to such diverse issues as drug trafficking (the illegal economy), tax evasion, and the burgeoning problem of deficits and debts (the unreported economy); productivity decline; and questions concerning the reliability of widely cited indicators of aggregate measures of economic activity such as GNP, personal income, and savings rates (the unrecorded economy).

The *illegal* economy consists of the income derived from the pursuit of economic activities that are expressly prohibited by law such as the traffic in drugs, prostitution, and gambling. The income derived from such activities in the United States is estimated to be in excess of $100 billion. The total social costs of such activities, in terms of increased crime, lost output, and the burdens placed on the penal and judicial system, have yet to be tabulated. Although it is this illegal economy that the public most often associates with underground activities, it is but one of several and by no means the largest nor necessarily the most consequential.

A much broader problem of underground activity is reflected in what has come to be called the *unreported* economy. It comprises the income that ought to be reported to tax authorities but is not. Many estimates of the size and growth of tax evasion have been based on studies of the evolution of cash payments. Despite the fact that many economists have predicted the advent of a "cashless society" in the United States, nonbank per capita cash holdings now amount to one thousand dollars and 45 percent of the value of the nation's currency supply is in the form of one-hundred-dollar bills. Moreover, recent Federal Reserve surveys suggest that American households admit to holding less than 12 percent of the nation's currency supply, which means that 88 percent of our currency is now regarded as "missing."

On the basis of independent audit studies of tax returns, the Internal Revenue Service now admits that unreported income on the federal personal income tax alone is in excess of $470 billion, and this estimate makes no provision for the unreported income earned in illegal activities. Lost tax revenues from tax evasion in the United States exceed $100 billion, suggesting that full compliance with tax laws would wipe out two-thirds of the current budget deficit.

Because the government also relies on tax data to estimate overall indicators of economic activity such as Gross National Product, a growing unreported economy will also give rise to an *unrecorded* economy comprising income that should be included in aggregate indicators of economic activity but is not. A recent yet largely unnoticed revision of the National Income and Product Accounts added $100 billion to the previous estimate of U.S. personal income simply to reflect the incomes that were misreported on the federal personal income tax.

A growing unrecorded economy threatens the veracity of the fundamental information system that monitors economic activity and forms the basis of both business and governmental policymaking. It can distort measures of growth, unemployment, inflation, savings, and productivity, as well as measures of income inequality. What begins as a mere statistical illusion can readily be transformed into real economic malaise and instability through well-intentioned government policy based on a systematically biased information system.

Studies that have attempted to trace the development of unreported and unrecorded incomes suggest that the United States as well as Western European nations experienced dramatic increases in underground activities during the latter half of the 1960s and throughout the 1970s. Suspected causes of this growth include higher tax rates, a decline in tax morality, and increased costs of compliance with government regulations. Some economists have argued that the observed stagflation and productivity declines of the 1970s, as well as the growing government deficits of the 1980s, are explicable in terms of a growing underground economy. In short, they view with concern the harmful consequences of underground economies. In democratic capitalistic economies, where government control is exercised by the application of rules, the violation of such rules is generally viewed as a deterrent to social well-being. If underground economies are viewed as an affliction of the developed world, then how can they serve as an elixir for the problem of underdevelopment?

This apparent paradox is only partially eased by the fact that de Soto makes relatively little use of the conventional underground concepts that have applied to developed nations, although he does take advantage of some of the measurement methods designed to estimate aggregate underground activity in Western nations. For example, he takes little note of the "illegal" economy, despite the well-documented traffic in cocaine in Peru. De Soto chooses to ignore the illicit drug industry in his conceptualization of informality, since it is directed toward illegal objectives. While some of his measurement techniques may inadvertently capture a portion of the cocaine trade, it is essentially omitted from his study.

The Peruvian study does make use of the "unreported" income concept, but rather than viewing it from the perspective of lost revenue to the state (tax evasion), de Soto sees tax compliance as a cost of remaining in the formal sector. Based on sample evidence from small formal industrial firms, he concludes that tax payments represent only 21.7 percent of the total costs of remaining formal. The major cost component (72.7 percent) is the cost of the administrative procedures required to remain formal.

De Soto's imaginative effort to document the costs of complying with the myriad of administrative procedures is a strong suit in his empirical analysis. By actually setting up an informal enterprise and wading through the bureaucratic procedures required to formalize it, de Soto's research team at the Institute Libertad y Democracia (ILD) had to spend 289 days to accomplish a task that would have required a few hours in the United States. These participant studies led him to the conclusion 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."

The Other Path also makes brief use of the "unrecorded economy" concept by citing the difficulties imposed on government monetary and fiscal policy when it is extremely difficult to obtain precise information about national economic performance. The ILD estimates that in 1985, "Peru was 28.7 percent richer than the national accounts indicated"

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and that "it is also likely that underemployment, unemployment, and inflation are overestimated." Are we to conclude that Latin America is in a better position to service and repay its $420 billion debt burden than is usually thought to be the case?

What precisely is the relationship between the informal economy and the current debt crisis in Latin America? If the constraints to growth imposed by the massive debt are as important as is claimed by the debt-ridden governments, then will de Soto's suggested policy initiatives be sufficient to loosen these constraints to growth? Even if legal reforms that unleash the dynamism of the informal sector are instituted, can these generate sufficient foreign reserves to make the repudiation of interest and principal payments on the debt less likely? *The Other Path* is silent on these issues.

The 'underground' economies of socialist countries

In the socialist countries of Eastern Europe, the Soviet Union, and China, the "underground economy" has been labeled the second, parallel, or unofficial economy. The *second* economy of these centrally planned nations is believed to comprise those economic activities that are generally beyond the control of the central planning authority. These essentially private activities are often illegal, unreported, and unrecorded. In an economy of planned scarcity, the unofficial economy functions to satisfy consumers' needs for those goods and services not provided by the state.

From the vantage point of the state, the second economy acts as a convenient buffer that helps to defuse economic dissatisfaction. Moreover, since unofficial economic activity is ubiquitous and largely illegal, the state is in a position to exercise enormous control over its citizens. By making most citizens de facto criminals by virtue of their participation in the second economy, the state can readily intimidate them through the discretionary enforcement of existing legal statutes.

But the second economy also poses real threats to the state apparatus. Its efficiency in the provision and allocation of scarce resources is a constant reminder of the waste and inefficiency of the official economy. The second economy therefore weakens public confidence in central planning and saps resources from the official sector, thus making the controlled sector even less efficient. It is therefore not surprising that the governments of centrally planned economies have maintained a schizophrenic stance toward the second economy.

Despite this equivocal attitude, the most important centrally planned nations have now initiated major institutional reforms that give greater legitimacy to informal activities. The reforms hope to reap economic benefits from the dynamism of the market-oriented second economy by subtly assimilating it into the official economy.

The risk posed by perestroika is a loss of political control. For once the second economy gains legal legitimacy, the state loses its political power of selective enforcement as well as its dominant economic control over the distribution of income and resources. Socialist nations now appear to be willing to risk a greater degree of reliance on second-economy market mechanisms, even at the cost of political control, in order to reap the expected benefits of more efficient production and allocation of resources. For some Western observers, these new policies imply that the Cold War has been won, but the economic difficulties now being experienced in the USSR and the recent retrenchment of reforms undertaken by China suggest that considerably more evidence is needed before the success of these movements can be reliably evaluated.

De Soto's policy prescriptions for Peru are germane to the reform movements now under way in socialist countries. The main tenets of his policy-reform proposals are the simplification, decentralization, and deregulation of the cumbersome existing economic and legal mechanisms. Specific proposals include the establishment of property rights, access to credit markets, and other legal protection for informal firms. De Soto strongly advocates the "debureaucratization" of the mercantilist state so as to lower transaction costs of doing business.

The Soviet Union has moved toward the establishment of property rights in agriculture, but it continues to resist radical reform of price controls. As de Soto's evidence for Peru suggests:

> Attempts to reduce the price of essential goods ultimately cause prices to go up. This is because any state-imposed price-control system necessarily involves politics and red tape and thus the possibility that, once they have been isolated from market forces,

prices will in fact be controlled by redistributive combines.

The violent public reaction to even minor efforts to dismantle subsidized prices in Latin America suggests that politicians are more likely to be persuaded by riots than by economists' assurances that higher prices are necessary to elicit increased production.

The Third World's underground economies

The Other Path makes no mention of the extensive research literature on informal economies in Third World nations. This omission is unfortunate for two reasons. First, it deprives the work of supporting materials that tend to bolster its conclusions. Second, it denies de Soto's contribution the context in which its innovations can be more readily perceived. For while there are important similarities between *The Other Path* and earlier works, there are also important differences.

During the 1960s, urban anthropologists focused attention on the most readily discernible participants in informal activities – the peddlers, petty traders, artisans, porters, and messengers who packed the streets of Third World urban centers. Were these groups to be regarded as a symptom of underdevelopment, a marginal class of migrants whose only alternative to unemployment was to eke out a subsistence income, or did they play some positive role in the development process itself?

The International Labor Organization's (ILO) 1972 study of informality in Kenya opted for the second interpretation. The ILO concluded that "far from being only marginally productive," the informal sector "is economically efficient and profit making . . . a sector of thriving economic activity and a source of Kenya's future wealth." Similarly, in 1975, the United International Bank for Reconstruction and Development praised the informal sector's "responsiveness to opportunity, its high degree of resourcefulness, and its entrepreneurial originality." De Soto's characterization of the informal sector is similar, "an extraordinary reserve of productive human resources which each day demonstrates amazing energy and ingenuity."

Earlier work also lends support to de Soto's contention that the informal economy's contribution to urban employment and output is quantitatively large. Webb's study of Peruvian informality concluded that as early as 1970, 53 percent of Lima's establishments were informal. The informal percentage for eight Peruvian cities was estimated to be 62 percent. These estimates are broadly consistent with de Soto's findings, which suggest that 48 percent of the economically active population is engaged in informal activities, accounting for "61.2% of work hours [and] 38.9% of the gross domestic product recorded in the national accounts."

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To arrive at these macro-estimates, the ILD relied on a variety of assumptions concerning workers' income aspirations and the particular sectors in which workers chose to seek employment. In addition, the ILD employed some of the same monetary methods that have been used to estimate the size and growth of underground economies in developed nations. Since the details of these laborious calculations are summarized in extensive data appendixes that were not included in the published volume, we must await their further scrutiny before making a final judgment concerning their reliability. Whatever the final verdict on the precision of these aggregate estimates of Peru's informal economy, they appear to be roughly consistent with Webb's earlier estimates (1975).

The studies that followed the ILO's research strategy placed great emphasis on the necessity of creating operational definitions of informal activities in order to measure differences between informal- and formal-sector wages, earnings, income distributions, education, skill levels, and technology, as well as the nature of linkages between the informal and formal sectors. These studies typically defined informality on the basis of worker characteristics or establishment size, whereas de Soto's criteria are essentially legalistic, focusing less on firm size and more on the extent to which workers or enterprises are licensed or regulated. Since the structure of existing data bases was not informed by de Soto's conceptual framework, he was required to pioneer new data collection efforts that have provided novel insights into the role of transaction costs and legal barriers to the development process.

De Soto ingeniously sets out to empirically estimate some of these transaction costs by maintaining detailed records of the enormous number of man-hours required to pursue such mundane tasks as obtaining building permits, setting up a formal store, establishing an informal market, and acquiring approval for land development. In these investigations, the author sought to avoid the most efficient route for overcoming bureaucratic barriers, namely the payment of bribes. Had these bribes actually been paid, the study would have yielded direct monetary cost estimates of these activities. It is unlikely, however, that this alternative methodology would have reversed his main conclusion concerning the importance of these costs as a hindrance to the development process.

Thus, while it would be inappropriate to credit de Soto with discovering Peru's informal economy, his detailed empirical examination of Lima's informal activities in housing, trade, and transportation (which makes up the first half of *The Other Path*) must be regarded as a model of thorough and illuminating urban economic research. His study provides a wealth of new evidence to support the breadth and resourcefulness of the informal economy. What is still required are estimates of the growth of informality over time; this will allow greater insight into the causes of informality and the dynamic of consequences of informality for the development process.

Despite the enormous infusions of foreign capital, technology transfers, and the myriad of policy panaceas proposed to encourage rapid development, the vexing question remains: Why do poor nations remain poor? On this central issue, de Soto parts company with earlier writers.

Conventional theory

According to many developmental economists, the fundamental problem of development lies in the inability of formal-sector firms to provide the necessary employment opportunities for the massive labor supply that typically migrates to urban centers. Since much of the formal sector's technology is imported, it is overly capital-intensive and labor-saving, and thus not suited to absorb the surplus labor attracted to Third World urban centers. From this perspective, the existence and growth of the informal economy represents a prime *symptom* of the development problem—a large pool of the underemployed, or "working poor." The policy implications of this analysis are to encourage small-scale enterprises to employ abundant labor by improving their links to the formal sector and by providing direct donor aid from international organizations and the central government.

De Soto's alternative "neoliberal" framework views the problem of development in institutional rather than technological terms. Here, de Soto parts company with the traditional development theorists' focus on constraints on labor, capital, and technology. Instead, he adopts a neo-institutional approach that has in roots in modern industrial organization theory. This approach focuses on the impediments to development brought on by the perversity of legal and bureaucratic institutions that deny property rights and access to capital, erect barriers to entry, and raise the transaction costs of engaging in business to such high levels that potential participants in the development process have little alternative but to adopt illegal means in the pursuit of normal entrepreneurial activities. The result is "a costly society in which formals and informals alike waste tremendous resources."

For de Soto, the informal economy is not the symptom of the development problem but rather the main hope for its solution. Neither technological nor financial donor aid will be successful unless the mercantilist state can be persuaded to give up its institutional stranglehold on economic activity, both formal and informal. What is required is market-oriented bottom-up growth, sustained and encouraged by new institutions that promote property rights and reduce transaction costs.

By identifying and estimating the transaction costs imposed by, in his words, "bad laws," de Soto is able to quantify the incentives that drive individuals and firms into the underground economy. Unlike authors of underground studies in developed economies, de Soto concludes that tax evasion is not the prime motivation for entry into the informal sector. The major costs of remaining formal are those required to comply with existing bureaucratic procedures. The consequences of these costs are "declining productivity, reduced investments, an inefficient tax system, increased utility rates, limited technological progress and a number of difficulties in formulating macroeconomic policies."

What distinguishes *The Other Path* from earlier work on informal economies in developing nations is the broad conceptual framework that guides its analysis of the informal economy and the novelty of its proposed agenda for change in Peru. In his role as political theorist, de Soto attempts to chart a new course that combines the most passionate elements of what now forms the extremes of present-day Peruvian politics.

De Soto's political agenda requires nothing less than the subversion of the mercantilist tendencies of Latin American governments. This "neoliberal" or "neoconservative" position seeks to establish a political alliance between those who share the aspirations of the poor and those who defend market-oriented economic development. The program for this new political amalgam seeks institutional changes that will simplify the functioning of the legal process through decentralization and deregulation. The "other path" therefore attempts to steer a course between the polarities that currently paralyze both the political and development processes.

From de Soto's perspective, it is the large informal economy that represents the constituency that paradoxically may be capable of circumventing what Arthur Okun has described as the inescapable conflict between equality and economic efficiency. Okun correctly recognized that "capitalism and democracy are really a most improbable mixture. Maybe that is why they need each other—to put some rationality into equality and some humanity into efficiency." This appears to be de Soto's ambitious goal, and the informal economy is his vehicle.

Previous studies lend support to de Soto's contention that the informal economy's contribution to urban employment and output is quantitatively large.

Few will conclude that *The Other Path* has definitely proven the workability of this optimistic prognosis, but fewer still will be able to ignore the challenge to further explore its possibilities.■