

Regulatory Reform in the Third World: The Case of Peru

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Regulation and its reform are now prominent themes in American politics. Despite their often technical character, regulatory reform programs successfully deploy a stirring set of political symbols and shibboleths. "Get the government off our backs," "eliminate waste," and "restore free enterprise" are appeals as visceral and irresistible as any in our political lexicon. Regulatory reform has become a hardy American perennial, the public policy equivalent of motherhood and apple pie.

The regulatory reform movement, however, has not enjoyed the same degree of success in developing countries as it has in the United States. The political traditions, legal institutions, cultural values, and economic forces that shape regulatory policy in developing countries differ vastly from their American counterparts. Daily life in many Third World¹ states is more communitarian and less individualistic than life in the United States, and pervasive regulation is often a key instrument of national policy, strengthening the dominance of large state-run and private corporations. Regulation is endorsed by the Left on ideological grounds, by government bureaucracies in order to retain their power and patronage, and by many on the Right as a way to maintain a secure, stable economic environment. Government regulation of economic activity has thus enjoyed an entrenched status in the Third World that is almost inconceivable in the United States, given our volatile, competitive political system and market-oriented economic principles.²

Today, however, the privileged position of governmental regulation is

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Both authors have also been consultants to the Institute for Liberty and Democracy in Lima, Peru, the organization that is the focus of much of this Article. Portions of the Article draw on unpublished memoranda and materials that the authors prepared or obtained while in Peru, and on other working manuscripts. These materials are on file with the *Yale Journal on Regulation*.

1. We use the term "Third World" throughout this Article only to draw an inevitably crude socio-economic distinction; perhaps "developing nations" would have served as well. This usage is not meant to refer to political or ideological groupings.

2. This is not to deny that a powerful pro-regulation impulse exists in the United States and will survive the current administration's efforts to subdue it. See Schuck, Book Review, 90 *YALE L. J.* 702 (1981) (reviewing *THE POLITICS OF REGULATION* (J. Wilson ed. 1980)).

weakening in some developing countries, and the *pas de deux* so often performed by American regulatory enthusiasts and critics is beginning to be performed on other national stages as well. Brazil, Chile, and Mexico are beginning to accept the World Bank's view that inefficient state-run enterprises drain scarce public resources and must be returned to the private sector.³ Similarly, Third World countries such as India increasingly believe that foreign capital should be welcomed rather than despised and that it will go elsewhere unless regulatory controls on foreign investment are relaxed.⁴ Even in Africa, where various forms of socialism have replaced colonial economies, some governments have reduced their reliance on price controls and subsidies.⁵ This rejection of state-directed economic activity reflects a growing disenchantment with the recent poor performance of planned economies compared to those economies with more dominant capitalist sectors.⁶ This incipient trend should be reinforced by the World Bank's pressures on debtor countries to adopt market-oriented reforms when they apply for "structural adjustment loans" (SALs).⁷ Hence, the time may be ripe for regulatory reform in certain areas of the Third World.

Some Third World proponents of regulatory reform, seeking to overcome their lack of experience and technical know-how, have looked to the United States, where the development of regulatory refinements has become something of a cottage industry in the last decade. That is precisely what happened recently in Peru. Certain public and private

3. Burns, *The Condition of the World Economy*, AEI ECONOMIST, June, 1986, at 5. In the early 1980's, deficits run by state-owned enterprises exceeded three percent of gross domestic product in Argentina, Brazil, Mexico, Peru, and Venezuela. T. ENDERS & R. MATTIONE, *LATIN AMERICA: THE CRISIS OF DEBT AND GROWTH* 65 (1984).

4. WORLD BANK, *WORLD DEVELOPMENT REPORT* 1985 128 (1985) [Hereinafter *WORLD BANK*].

5. Burns, *supra* note 3, at 6.

6. See *A New Age of Capitalism*, TIME, July 28, 1986, at 28-39. Indeed, Soviet scholars themselves have recognized the disparity in economic performance between market and state-controlled economies in less developed societies. See HOUGH, *THE STRUGGLE FOR THE THIRD WORLD: SOVIET DEBATES AND AMERICAN OPTIONS* 84-85 (1986).

7. For an evaluation of the Bank's structural adjustment lending program through 1984, see F. YAGCI, S. KOMIN & V. ROSENBLAUM, *STRUCTURAL ADJUSTMENT LENDING: AN EVALUATION OF PROGRAM DESIGN* (World Bank Staff Working Paper No. 735, 1985). Although the Bank started the SAL program in 1980, SALs should become more important in the wake of the so-called "Baker Plan" initiative, advanced by the Secretary of the Treasury, James Baker, in the fall of 1985. The plan calls for commercial banks and the World Bank to advance up to \$25 billion in additional loans through 1990 to countries that commit themselves to "structural adjustment," that is, to undertake reforms including liberalization of import barriers, devaluation of artificially inflated exchange rates, "privatization" of state-owned enterprises, and removal of subsidies. The World Bank's own structural adjustment lending program, even without the substantial commitment by commercial banks that the Baker Plan envisions, is likely to encourage market-oriented policies in heavily indebted countries with no other sources of funds to service mounting debt obligations. N.Y. Times, Oct. 3, 1985, at A1, col. 1, Pine, *U.S. Proposal On World Debt Faces Hurdles*, Wall St. J., Oct. 8, 1985, at 35, col. 1.

organizations saw a need to reform their country's economy and enlisted a number of American academics and analysts—including the authors of this Article—to help them transplant ideas and institutions that had germinated and flourished in the United States into the seemingly inhospitable soil of the Peruvian political and legal culture.

This Article describes that exciting but profoundly chastening attempt to launch a kind of “non-technology transfer” program in the area of regulatory policy and distills the project's significance for similar reform projects in other countries. Although the Article inevitably reflects our own involvement in and sympathies toward the project, we have tried to achieve sufficient detachment to allow us to draw some lessons from our experience.

The Article is organized as follows. Part I describes Peru's recent economic and political history and condition. Part II summarizes the structure and analytic foundations of the regulatory reform project. The project's avowed objective was to dismantle Peru's “mercantilist” system, in which large, rent-seeking corporations had successfully enlisted the government's regulatory authority to suppress competition. Part III further describes Peru's existing economy and discusses three central elements of the reform strategy: (1) a new system of *property rights* designed to reduce corruption, encourage entrepreneurial activity, and make markets more efficient; (2) a new body of *administrative law* designed to end bureaucratic abuse of regulatory power and encourage public participation in regulatory policy making; and (3) a new process of technocratic and political *regulatory analysis* designed to expose and limit rent-seeking regulation that chiefly benefits politically influential economic interests and imposes large costs on society. Part IV describes how these initiatives were instituted, implemented, and eventually frustrated by a lack of governmental enforcement and support from an apathetic private sector. It then speculates about the prospects of such reforms. The Article concludes with some general observations about the techniques and prospects for regulatory change in societies very different from our own. We emphasize that, while regulatory reform is not a panacea for the staggering economic problems faced by Peru and other developing countries, it constitutes an important strategy for progress.

I. Peru's Recent Economic and Political History

Peru is a desperately troubled nation. In 1985, Peru's gross domestic product (GDP) per capita stood at approximately \$650, down roughly

forty percent from its 1981 peak.⁸ Half of the nation's almost nineteen million residents were unemployed or underemployed,⁹ a condition that aggravated the gross inequalities in income and wealth distribution. The \$14 billion owed by Peru to foreign creditors was equal to roughly seventy-five percent of the country's annual GDP.¹⁰ At the same time, the prices of Peru's official export goods—primarily copper, oil, silver, and zinc—were severely depressed, on average thirty-five percent below 1980 levels.¹¹

The recent deterioration in the Peruvian economy dashed hopes that had risen during preceding decades. Real manufacturing output, for example, had increased at roughly a nine percent annual rate between the late 1950's and middle 1970's, a pace that outstripped the overall economic growth rate for the same period.¹² In the late 1970's, rising prices of Peru's primary mineral exports actually produced a surplus in the balance of trade, following serious deficits in prior years.¹³

Peru's macroeconomic difficulties of the 1980's have been accompanied by microeconomic problems. State ownership of much of the banking sector, coupled with interest rate controls, has produced credit rationing that favors large, highly visible, and capital-intensive projects, to the detriment of smaller entrepreneurs who must rely on more informal funding sources. Peru's large mining sector, which is highly dependent upon price levels set in the world market, is severely depressed. Its fishing industry was devastated in 1983 by climatic changes in ocean currents and has still not recovered. In addition, its agricultural sector was debilitated in 1983, by both severe flooding and drought.

The economic problems in Peru have added significance in light of the fragility of its democratic institutions. Prior to 1980, the country was ruled by military dictators for twelve years: first by General Juan Velasco

8. Ryser & Wippman, *Alan Garcia is More than the Bad Boy of Latin Politics*, BUSINESS WEEK, Sept. 30, 1985, at 62, 64.

9. Roett, *Peru: The Message from Garcia*, FOREIGN AFFAIRS, Winter 1985/86, at 274, 279. While it is true that nearly half the workers are classified as underemployed, this reflects official statistics which do not consider informal workers as employed.

10. Washington Post, Jan. 20, 1985, at H6, col. 3; see also WORLD BANK, *supra* note 4, at 178.

11. INTERNATIONAL MONETARY FUND, INTERNATIONAL FINANCIAL STATISTICS, June, 1986, at 392-93. Even as the country's official export economy flounders, however, its unofficial cocaine economy may be booming. According to some, coca paste is Peru's largest export, bringing in reportedly \$800 million a year. Malcomson, *The Cocaine Economy: Scott Malcomson Reports From the Jungles of Peru*, THE VILLAGE VOICE, August 26, 1986, at 15. Government efforts to eradicate the coca trade, while stepped up by President Garcia, have met serious opposition in the form of general strikes and localized violence. Meanwhile, Peruvian coca farmers use government loan money to improve agricultural production. *Id.* at 16.

12. PERU: A COUNTRY STUDY 149 (R. Nyrop ed. 1981).

13. INTERNATIONAL MONETARY FUND, INTERNATIONAL FINANCIAL STATISTICS, issues from 1980-1985.

Alvarado (1968-75) and then by General Francisco Morales Bermudez (1975-80).¹⁴ These military regimes interrupted the civilian government of President Fernando Belaunde Terry, who had been elected President in 1963. In 1980, elections returned Belaunde to power, but his rule was highly ineffective. Not only did the economy collapse during his tenure, but his administration also failed to stem the rise of Peru's violent Maoist guerilla group, *Sendero Luminoso*, or "Shining Path." Insofar as any coherent political program can be deduced from its terrorist behavior, *Sendero Luminoso's* political agenda is to transform Peruvian society by returning the country to its agrarian roots. During Belaunde's five years in office, *Sendero Luminoso* spread its terrorist activities from the rural mountainous area of Ayacucho Province to Lima itself, where the group continues to bomb and attack the city's infrastructure.¹⁵

In 1985, Alan Garcia, a young politician who had enjoyed a rapid rise to power in the American Popular Revolutionary Alliance Party (APRA), was overwhelmingly elected President. His election reflected widespread disaffection with the previous government and national impatience with steadily deteriorating economic conditions. Although his campaign promised few specific courses of action, Garcia initiated sweeping reforms immediately upon assuming power in July, 1985.

The new President introduced an austerity program that included controls on foreign exchange to arrest the flight of capital from the country, increases in gasoline prices, and devaluations of the Peruvian currency. At the same time, Garcia implemented measures designed to help consumers and wage-earners. These included price controls on basic goods, cuts in interest rates, and increases in the minimum wage and government worker salaries.¹⁶ Garcia's nationally most popular and internationally most controversial step, however, was to announce that Peru would henceforth limit its annual debt service payments to ten percent of annual exports. In October, 1985, Garcia announced a second set of measures which included further cuts in interest rates and selective relaxations of price controls. He also moved aggressively to subdue *Sendero Luminoso* and to curtail Peru's drug traffic, estimated to account for \$500-\$800 million in export earnings annually.¹⁷

14. PERU: A COUNTRY STUDY, *supra* note 12, at 39-58. See also Roett, *supra* note 9, at 275-77.

15. See Roett, *supra* note 9, at 276-77. During one week in February, 1986, *Sendero Luminoso* guerillas bombed six embassies and 13 other targets in Lima. N.Y. Times, Feb. 23, 1986, at A5, col. 2. From February, 1986, to May, 1986, the military detained 38,111 people and killed four while "fighting [an] upsurge in urban guerilla violence." N.Y. Times, May 9, 1986, at A9, col. 2.

16. Roett, *supra* note 9, at 279-281; N.Y. Times, Aug. 2, 1985, at D4, col. 1.

17. Roett, *supra* note 9, at 279-281; N.Y. Times, Sept. 1, 1985, at 1, col. 5. See also Malcomson, *supra* note 11. The two problems are related. *Sendero Luminoso* has proven popular in areas of the country where the government has mounted anti-drug campaigns.

Garcia's bold actions by no means eliminated the immense problems that his administration inherited. The inflation rate has receded from triple-digit levels, but remains high. Peru's desire to attract new foreign funds was frustrated in October, 1985, when United States bank regulators declared Peru's debt to America's commercial banks to be "value-impaired," a move that requires these banks to set aside steadily larger reserves against their Peruvian loans, which in effect requires that they write off increasing fractions of those assets.¹⁸ Most recently, Peru's decision in August, 1986, to refuse to adhere to the repayment schedule requested by the International Monetary Fund (IMF) prompted a halt in IMF lending to the country, which has in turn jeopardized additional World Bank financing.¹⁹ Garcia's decision in June, 1986, to strike back militarily against a prison uprising organized by *Sendero Luminoso* resulted in over 300 deaths, contributed to political tensions inside Peru, and renewed charges that the government is violating human rights.²⁰

The Garcia administration still faces a daunting set of tasks. The most important will be to devise and implement a macroeconomic policy capable of lifting the national economic growth rate without relying on additional outside financing, which probably has been foreclosed by Garcia's action to limit debt service repayments. Although this goal will at best be extremely difficult to achieve, it may be impossible unless Peruvian policymakers also manage to curb excessive regulation and create a more efficient property rights regime. Burdensome regulation has forced resources to be used in costly compliance measures or, as is often the case, for the payment of bribes rather than for productive investment. A poorly developed system of property rights has retarded investment and innovation. The absence of any meaningful system of administrative law has made reform almost impossible. How these relationships have been discovered and documented is the subject of the next Part.

18. See N.Y. Times, Oct. 4, 1985, at D14, col. 5. In 1979, Congress established an interagency committee of bank regulators to assess the quality of bank loans to debtor countries. This Interagency Country Evaluation Review Committee is composed of representatives from the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. When a country has not paid interest on its loans for six months and is not working with the International Monetary Fund to restore its debt service, the Committee must classify loans to that country as "value-impaired." Under the International Lending Supervision Act, this designation requires banks to set up a risk reserve on such loans. Typically, the initial reserve is 10% of the loan value; the reserve must grow steadily as long as the designation applies. The reserve procedure is effectively equivalent to a write-down of the loan amount, with the write-downs charged against current income of banks that have such loans in their portfolios. For a description of this process, see Stokes, *Mystery Surrounds Agenda, Decisions of Foreign Loan Review Committee*, NATIONAL JOURNAL, Sept. 21, 1985, at 2136-41.

19. N.Y. Times, Aug. 16, 1986, at A38, col. 4.

20. N.Y. Times, June 28, 1986, at A2, col. 3. Other reports put the number of deaths as high as 400. Wall St. J., June 20, 1986, at 1, col. 3.

II. The Project's Beginnings

This Part offers a history of the reform project developed by the Peruvian reform advocates and their American advisors, a description of the economy that is the project's main concern, and an explanation of the problems that regulation causes in Peruvian society.

A. *Discovering Informality: The Institute For Liberty and Democracy*

The Peruvian protagonist of our story is Hernando De Soto. Now in his early forties, De Soto is a member of a prominent family of diplomats; his father was an ambassador and his brother is currently the top aide to Javier Perez de Cuellar, the Peruvian Secretary General of the United Nations. After being educated both in Peru and in Europe, De Soto remained abroad and eventually became the general manager of a major international engineering firm based in Switzerland. In the late 1970's, De Soto returned to Lima and entered private business. Politically well-connected and unusually cosmopolitan for a Peruvian his age, he was appointed by the new President of Peru, Fernando Belaunde Terry, to the governing board of Peru's central bank.

When he returned to Peru, De Soto, who had spent most of the previous fifteen years in Europe and the United States, was struck by some of the changes that had overtaken Lima. During his absence, the capital city had roughly doubled in size—from a population of 2.3 million in 1965 to 4.5 million in 1980—largely due to an avalanche of immigration that brought masses of Indians from ancient villages in the Andes to the dusty plain in which Lima is situated. Once there, the new arrivals immediately “invaded” the barren, unoccupied government-owned land at the ever-extending outskirts of the city and built rude dwellings that were often no more than cardboard shacks. These invasions were widely discussed throughout Peru, but De Soto noticed something about the squatters' areas that most other observers had missed. Often, within a relatively short period of time, some of these illegal, jerry-built settlements, known as *pueblos juvenes*, flourished. Amid the destitution and apparent disorder, enclaves would emerge in which one could observe permanent housing, urban infrastructures, and neighborhood amenities.

De Soto also noticed—one could hardly miss it—that the streets of Lima were lined with a myriad of street vendors, known as *ambulantes* because of the mobility of their bicycle-pulled or hand-pulled merchandise carts. These vendors sold food, clothing, and a bewildering variety of other goods. None had the municipally required license to do business, yet they reappeared daily at the same outdoor locations, seldom engaged in “turf”

disputes with their fellow vendors, and were rarely disturbed by the Lima police.

Fascinated by these economic arrangements, De Soto resolved to learn more about them. This was not an easy task; they were so much taken for granted that Peruvians seldom discussed them. De Soto even coined a term for these illegal but open activities: "informality" or "the informal sector." This term was meant to contrast with activities conducted under the authority of Peru's "formal" legal system, which defines and protects recognized property rights, governs "legitimate" commercial conduct, and adjudicates certain disputes. With the encouragement of some prominent Peruvians—including Richard Webb, director of Peru's central bank, and Mario Vargas Llosa, the nation's most celebrated author and a political figure in his own right—De Soto established a research and advocacy organization, the Institute for Liberty and Democracy (ILD or "the Institute").

To help raise funds for the Institute, De Soto organized international conferences on the Peruvian economy and the phenomenon of the informal sector. To these conferences, financed by various American foundations and the United States' Agency for International Development, he invited leading figures from the worlds of economic theory, economic development, international organization, and Peruvian politics.²¹ Drawing upon funds generated by the conferences, De Soto hired a small staff of young, energetic lawyers and economists for the Institute, many of whom already had considerable experience in various ministries of the national government. This group—which resembled a market-oriented, Peruvian version of "Nader's Raiders"—set to work assembling a mass of information about the nature and extent of informal economic activity in Lima. By generating a torrent of reports, newspaper and magazine articles, TV appearances, and other public exposure, the Institute tried to impress upon Peru and other South American countries the importance of the informal sector to the nation's economic life.

B. *Peru's Informal Economy*

The Institute's findings²² were astonishing, even to De Soto. In areas as diverse as housing, retailing, personal and commercial credit, urban

21. Among those attending the conference were economists Friedrich von Hayek and Milton Friedman; U.N. Secretary General de Cuellar; Jan Tumlir, former chief economist of the General Agreement on Tariffs and Trade (GATT); aides to Peruvian President Belaunde; and representatives of the Peruvian Communist Party.

22. Most of the statistical information presented in this Part was gathered by the Institute in the course of its research and is recorded, in Spanish, in memoranda and unpublished manuscripts on file with the *Yale Journal on Regulation*. Some of the figures, especially population and economic

transportation, and manufacturing, the Institute discovered a complex web of informal economic activities that competed with, and in some cases dwarfed, the formal sector. According to the Institute, this “other” economy, which is not “underground” but in fact operates quite openly, actually constitutes the heart of Peru’s real economic life.

The Institute found, for example, that the population invasions that create the *pueblos juvenes* are typically undertaken by well-organized groups of as many as 20,000. Such large groups, consisting as they do of potential voters and, if evicted, of potential rioters, cannot be ousted by the formal authorities or by competing groups of residents. Their invasions are coordinated by professional promoters who specialize in securing municipal services and negotiating with political leaders and the police. Within hours of the beginning of an invasion, the new residents draw boundary lines to mark off their individual plots. These boundaries are enforced by the group when disputes arise. Over time, as the residents accumulate savings from their meager incomes and their expectations of remaining in their new place ripen, the initially bare wooden structures are improved with bricks, gardens, sidings, second stories, and roofs.²³ According to the Institute, the forty-seven percent of Lima’s citizens who currently live in *pueblos juvenes* have already invested an estimated \$8 billion in residences that were originally—and remain—illegal.

Informality is, if anything, even more widespread in the urban transportation sector, particularly in Lima’s municipal bus system. ILD’s research has determined that almost nine of every ten passengers ride buses that are operated either by “semi-formal” drivers—those with bus routes granted under a municipal franchise and who charge regulated fares, but who generally do not report their incomes to the tax authorities—or by purely informal drivers, who lack a franchise and charge what the traffic will bear. These informal drivers apparently provide a far more highly-valued service than the formal transportation system, evidenced by riders’ willingness to pay higher fares for it. Moreover, they have developed a market in which bus routes are effectively traded and enforced without resort to formal law.

Informality also dominates the activities of small commercial entrepreneurs, particularly an estimated 84,000 *ambulantes* who offer a full menu of perishable and durable goods for sale in competition with larger, legal,

statistics, have been presented in the Institute’s continuing series of articles in the weekly magazine *Caretas* from June, 1985 to the present. The authors’ personal summaries gathered from interview notes are also on file with the *Yale Journal on Regulation*. For an analysis of the theoretical aspects of Peru’s informal economy, see P. Reuter & S. Salop, *The Economic Consequences of Informality: A Preliminary Theoretical Analysis*, (July, 1984) (unpublished manuscript).

23. It last rained in Lima sometime in the early 1970’s.

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 per slice. The organizations also collect dues that have enabled the informal *ambulantes* of Lima to finance the construction of over 240 local markets there. In contrast, the municipal government of Lima has constructed only four local markets for licensed vendors.

Because it is least visible, the extent of informality in the industrial sector in Peru is not yet well-documented by the ILD. However, there is no question that informal industries exist. The Institute has learned that numerous small manufacturing enterprises—textile facilities, repair shops, and the like—are operated informally in Peru's urban areas. To avoid detection, they are kept small, generally operating in hidden locations with fewer than a dozen employees.

In the aggregate, according to Institute estimates, over half of Peru's population conducts most of its personal and commercial affairs in the informal sector.²⁴ Clearly, two economies operate simultaneously in the country—one officially sanctioned and protected by the formal legal system, and another effectively beyond the reach of government and the law.

De Soto recognized that this state of affairs was damaging Peru's national and local economies. Although he supposed that the country's legal structure was responsible for the problem, he initially had no clear idea of precisely how the law had contributed to its growth and thus was unable to devise a solution. De Soto was a keen, sophisticated observer, but one without a theory that could integrate this mass of new information into an intelligible reality, much less a remediable one.

De Soto began to read in the law and economics literature and soon found his theory. He immersed himself in academic discussions of the economic effects of different legal rules, the ways in which a redefinition of property rights could 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 inform him and the Institute's staff, and who could assist them in applying the insights of law and economics analysis to Peruvian society. The trip was successful; in late 1983, a steady stream of American lawyer-economists from universities and research institutes throughout the United States began travelling to Lima to advise the Institute.²⁵

24. Litan, Morales-Bayo & Fernandez-Baca, *International Reforms in Peru: A Promising Road Out of the Debt Crisis*, J. ECON. GROWTH, 2d Quarter 1986, at 28, 29 [Hereinafter ECONOMIC GROWTH].

25. De Soto's first American contact was Judge Robert Bork, who referred him to Professor Warren Schwartz of the Georgetown University Law School. The two authors of this article became

With the Americans' help, the Institute began to integrate into a patterned mosaic its painstakingly-gathered fragments of data about diverse informal activities. It began to see the explosive growth of the *pueblos juvenes*, for example, as a response to the severe housing shortage produced by governmental controls, and to the byzantine regulatory system for securing legal title to unoccupied land in Lima. The Institute found that new arrivals who want to acquire land must successfully negotiate a bureaucratic maze consisting of more than 200 stages and consuming a minimum of seven years.²⁶ This process is complicated by the reluctance of Peru's central government to cede the barren land that it owns to the provincial or municipal governments, which have authority to grant title to individual applicants.

The Institute also found that bureaucratic lethargy and red tape caused much of the informality in the commercial sector. When the ILD attempted to test the responsiveness of the regulatory system by forming a small manufacturing business, 301 days were required simply to obtain all the necessary government approvals and licenses for beginning operation.²⁷ Rigid labor laws provide additional incentives 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 proportion of their profits with their workers.

The explosion of informality in Lima's urban bus system was likewise found to be caused by regulatory overkill. By keeping regulated bus fares extremely low—less than ten cents per ride despite fuel costs equivalent to, or even higher than, those in the U.S.—the city has encouraged drivers of semiformal busses, who carry roughly half of all daily traffic in Lima, to deviate from their franchised routes and pick up passengers anywhere. As a result, these busses are crowded and their routes are labyrinthine. Many purely informal busses, which carry roughly half of the municipal traffic, offer more direct service under more comfortable conditions but at higher, unregulated prices.

involved in the Institute's work through Professor Schwartz. Many others have also since participated, including: Stuart Butler of the Heritage Foundation; Robert Crandall of the Brookings Institution; Charles Goetz of the University of Virginia Law School; Thomas Hopkins of the University of Maryland; Peter Huber, a Washington-based attorney and scientist; Paul Kahn of the Yale Law School; Ron Kirby of the Urban Institute; Saul Levmore of the University of Virginia Law School; Jerry Mashaw of the Yale Law School; Richard Taranto, a Washington attorney; Gordon Tullock of George Mason University; and Lawrence White, formerly of New York University and now a member of the Federal Home Loan Bank Board.

26. ECONOMIC GROWTH, *supra* note 24.

27. One of the researchers tried the same experiment in Tampa, Florida and finished in three and a half hours. Martin, *In Lima, Even Buses and Clothes are Part of Informal Economy*, Wall St. J., Aug. 15, 1984, at 1, col. 1.

Finally, the ILD found that regulation contributes to the existence of informal credit arrangements. Tight interest rate controls have enabled eligible borrowers to obtain financing at negative real rates of interest, but at the same time have forced formal credit institutions such as banks and savings associations to ration credit. Not surprisingly, this rationing system has rewarded firms and individuals that borrow in the formal sector. Informal entities generally lack the income or respectability necessary even to get a foot in the door at a bank. Equally important, due to the illegal status of their operations and of the loans that they manage to obtain, informal borrowers typically lack enforceable property rights in merchandise and housing that could otherwise serve as collateral.

C. *Regulation and Informality*

The thriving informal sector and the conditions that encouraged and sustained it imposed severe costs on Peruvian society. The most obvious costs imposed were economic. Bribes to public officials and other attempts to avoid detection by those who could shut down informal firms had become an important cost of doing business informally, one that drained valuable resources away from socially productive activities and redistributed money from typically poor individuals to police and other relatively more affluent officials. Operating illegally and in remote areas of the city, informal firms could not achieve their growth potential by fully exploiting economies of scale, advanced technologies, advertising, and access to markets. Their incentives to save and invest were also weakened (although not eliminated) because their property and contracts received no legal protection. For example, one Institute survey of investment in housing developments found that residents who had formal legal title to their homes invested significantly more in housing—even after the data were adjusted for income and age of housing—than did residents in the *pueblos jóvenes*, in which property rights are protected only informally.

Such economic costs extended well beyond the informal sector to formal firms and to the government itself. The existence of informal firms meant in many cases that different firms competing for the same customers were not playing by the same rules. By complying with the law, formal firms were obliged to incur certain costs that their informal competitors simply avoided. This problem might have been less troublesome if the laws or regulations in question were unsound, but competitive distortions were not confined to those circumstances. The formal sector was disadvantaged by its compliance with wise and unwise regulations alike. Finally, many in the informal sector were assumed not to pay taxes, thereby depriving the

government of much revenue, while bribes in lieu of taxes were privately appropriated by public officials.

The political costs of widespread informal activity were probably even greater than the economic ones. Flagrant disregard for the law could only erode popular confidence in government and the legal system. The wink and the nod were hardly fit symbols for an aspiring democratic regime. Especially where self-government and democracy are in their infancy and terrorism is an almost daily occurrence, respect for legal institutions is a precious, expendable resource that must not be squandered. Informality on the scale found in Peru, and the bribery and cynicism so essential to its maintenance, can create an environment in which *all* laws come to be seen as impertinent impediments to individual economic advancement.

III. The Reform Strategy

This Part examines Peru's formal, "mercantilist," economic sector and presents the three central elements of the Institute's reform strategy: a new system of property rights, a new body of administrative law, and a new process of regulatory analysis.

A. Peru's "Mercantilist" Economy

The Institute had documented the existence and spread of a massive informal sector that not only burdened the already weak economic structure of Peru but also threatened to rend the nation's fragile social, legal, and political fabric. The Institute's research had identified the regulatory system as a major cause of that problem. To develop this diagnosis, De Soto synthesized the conventional law and economics analysis of regulation with his own context-specific perceptions about the distinctive historical and cultural setting of Peru's political economy. The social consciousness and public philosophy governing Peru, he believed, were fundamentally hostile to the cultural, economic, and political values necessary to support a free market.

This Peruvian attitude should be distinguished from the kind of anti-market consciousness predicted by Marx or by Schumpeter²⁸ since it did not arise out of Peru's reaction to the dynamics or culture of capitalism. De Soto believed that Peruvians had embraced a socialistic ethos without ever having experienced the stage of capitalism. This resembled the same kind of inversion of Marx that Lenin contrived in the Russian Revolution. In doing so, De Soto observed, Peru had adopted a "mercantilist" political economy.

28. J. SCHUMPETER, *CAPITALISM, SOCIALISM, AND DEMOCRACY* (1947).

De Soto's description of Peruvian mercantilism confirmed the preconceptions of many of his American advisers. At a rhetorical level, it bore strong similarities to what Ralph Nader has called "corporate socialism," or "socialism for the rich, capitalism for the poor." At a more abstract level, this mercantilism bore strong similarities to the Chicago School-style public choice and law and economics analyses, which predict the "regulatory capture" of vote-seeking politicians by rent-seeking corporate interests (and vice-versa). In a society that had never developed strong private institutional defenders of competitive markets, mercantilism could only preserve the dismal economic and political status quo, choking off prospects for significant change. De Soto concluded that genuine reforms could not be realized simply by attacking particular anti-competitive regulations. The underlying institutional and ideological foundations that supported mercantilist regulation had to be challenged so that competitive enterprise—that of the *ambulantes*, the *pueblos juvenes*, the would-be manufacturers, and the illegal bus drivers—could flourish under the protection, rather than the threat, of the formal law.

De Soto's task was formidable. He knew, however, that he was not wholly without resources. In a society in which the number of influential people is relatively small, De Soto enjoyed wealth and excellent access to the top levels of the Belaunde government, including the President himself. Like Nader, he possessed impressive political entrepreneurial skills. He could effectively manipulate elite opinion, raise money, and inspire media attention both in Peru and abroad. Employing a dramatic rhetoric, De Soto could mobilize widespread discontent with the manifest failures of the existing parties, ideologies, and programs, and could exploit the growing demands for thorough-going economic reform in Peru. He could appeal to national idealism and attract some of the most talented young professionals in Peru. He could draw upon a unique research organization to substantiate his empirical data. Finally, he believed fervently in a powerful theory, one that could help Peruvians make sense of what they saw and felt.

B. *The Institute's Reform Initiatives*

1. *Property Rights*

De Soto proceeded along separate but related avenues to reform. First, he sought to jettison the traditional system of mercantilist regulation that had engendered informality. Mercantilism would be replaced by a new system in which property rights would be redefined to encourage and protect enterprise rather than stifle it and force it underground. Since informality itself was not the problem, De Soto rejected a "law and order"

approach emphasizing more effective enforcement against the informal sector. In Peru, bribery is a way of life. The income generated from it is generally expected to supplement meager official salaries. A “law and order” strategy would have increased both the demand for and the cost of bribes, thereby aggravating the existing system’s inefficiency and its regressive distributional consequences.

De Soto had a more important reason for trying to legalize informal activity rather than suppress it. Most activities in which the informal sector engaged were legitimate and socially productive. Only a perverse mercantilism had rendered them illegal in the first place. Raising the cost of such activities would obviously disadvantage all Peruvians who benefited from them. Instead, De Soto advocated replacing “administrative rights”—governmentally conditioned, highly restricted licenses to do business—with property rights that would facilitate economically beneficial transactions by expanding and protecting the field of permissible competition. In some cases, for example where price controls are imposed on selected commodities, a reform strategy based upon property rights could lead to complete deregulation. In areas such as food safety, where continued regulation is justifiable, the property rights strategy implies only a relaxation of controls or a redesign of regulatory techniques.

De Soto expected intense resistance to deregulation. No real political constituency for regulatory reform yet existed in Peru, and the Institute’s analysts were not yet in a position to make the case for deregulating any one sector. De Soto therefore chose to defer temporarily proposals for substantive regulatory reform of particular markets. Instead, he sought to establish procedural and methodological reforms that could be applied across the board to all regulations. In the long run, he felt, such reforms would help to curtail or eliminate existing undesirable regulations while at the same time making it more difficult for mercantilist bureaucrats to adopt new regulations. This strategy drew him toward several regulatory reform techniques that had been employed in the United States, techniques that centered on the related areas of administrative law and regulatory analysis.

2. *Administrative Law*

The system of administrative law so familiar to the Institute’s American analysts was quite alien to Peru. In particular, American administrative law contains three structural features unknown to Peruvian law. First, United States law requires that an elaborate and at least minimally rational public process precede the issuance of final regulations. Second, independent courts impose substantial supervisory control over regulatory

decision-making, including some exercises of administrative discretion. Third, individual citizens and private groups in the United States have a legally recognized opportunity to play an active role at every stage of the regulatory process, from the initiation of regulatory proposals, to the examination of most documents and evidence on which regulations purport to be based, to the invocation of several possible stages of judicial review. In contrast, the process of rule-making in Peru was remarkably straightforward: a ministry wishing to adopt a rule simply published it in final form in *El Peruano*, the official government newspaper. Private individuals or groups had no legal right to participate in the rule-making process in any way, and there were no sanctions, judicial or otherwise, for routine bureaucratic illegality.

3. *Regulatory Analysis*

If Peruvian administrative law seemed rudimentary, Peruvian regulatory analysis was non-existent. The visiting Americans fully anticipated this; indeed, formal regulatory analysis remained quite controversial in the United States even a decade after it had first been required.²⁹ However, the Americans were puzzled to learn that even the Institute's staff, if not De Soto himself, had serious misgivings about such a reform.

The Institute's economists patiently informed the Americans of some of the hard realities of regulation in Peru. The government employed very few economists or policy analysts, and none was highly trained by American standards in the art and science of regulatory impact analysis. Even the Institute's economists, who De Soto insisted were among the most sophisticated in the country, had almost no experience with such techniques. Furthermore, the government collected little of the data that the American analysts took for granted, data necessary in order to appraise the effects of regulation. Whatever information there was remained under the control of the ministries, which jealously guarded the public's access to it. Even relatively simple regulatory analyses would take time and money that private groups in Peru lacked and would probably be completed long after the ministries had issued the regulations in question. Finally, there would be little political support for regulatory analysis. Its primary beneficiaries—informal entrepreneurs burdened by mercantilist

29. Compare Morrison, *OMB Interference with Agency Rulemaking: The Wrong Way to Write a Regulation*, 99 HARV. L. REV. 1059 (1986) (Congress should prohibit Office of Management and Budget oversight of substance of agency rules) with DeMuth & Ginsburg, *White House Review of Agency Rulemaking*, 99 HARV. L. REV. 1075 (1986) (OMB review is necessary tool to insure consistency of agency rules with administration's broader objectives).

regulations—were unorganized, unsophisticated, and reluctant to become too visible lest they be harassed by the police.

De Soto reminded his staff that the Institute had few alternative options and so urged them to be bold and self-confident. His exhortations took on a special urgency in late November of 1984, when the Council of Ministers of the Belaunde government issued a Supreme Decree under a special, time-limited delegation of authority from the Peruvian Congress. De Soto had helped draft the decree; moreover, he had appointed the Council's director (who was the President's nephew) to the Institute's advisory board.

The Supreme Decree³⁰ provided that, with certain exceptions, all regulations that "could affect . . . the incorporation of the informal sector into the legal system or the maintenance of the formal sector therein" had to be published in *El Peruano* before their effective date. It further required that the publication include a brief explanation of why the proposed regulation was "necessary for . . . the public interest" and state that any interested individuals or groups from the public or private sectors could "submit their opinions or suggestions" to the relevant ministry. In turn, the ministry was obliged to "consider such suggestions and opinions so as to evaluate the convenience of their incorporation into the final text."

The Supreme Decree also established a key role for the National Committee on Economic Rights (CODE). At De Soto's urging, CODE had been established by an earlier decree to coordinate the government's new initiative on behalf of the informal sector. De Soto had seen to it that CODE would be directed and staffed by lawyers and economists from the Institute. The Decree provided that CODE would specify the criteria, procedures, and formalities applicable to the publication requirement, along with the kinds of justifications required of the issuing ministry in its publication notice. De Soto finally had his long-sought opportunity to implement regulatory reform.

IV. Implementation of the Plan

A growing political incubus endangered the implementation of the November decree. The first Presidential elections since 1980 were scheduled for April, 1985; Belaunde was retiring and a new President would assume office in late July. De Soto, along with most political observers, was confident that Belaunde's party, which was widely regarded as ineffective and enervated, would lose. Absent a military coup, which was

30. Supreme Decree No. 071-84-PCM (1984) (English version on file with the *Yale Journal on Regulation*).

viewed as highly unlikely, Belaunde would have to surrender office to Alan Garcia, the charismatic, thirty-five-year-old leader of the APRA opposition. De Soto was acquainted with Garcia—like most members of the Peruvian elite, they had attended the same schools—and hoped to develop a working relationship with him. Still, Garcia was an unknown quantity, and De Soto doubted that APRA, which had been kept out of power for more than a half-century by force and fraud,³¹ could be counted upon to retain, much less implement, a politically controversial regulatory reform program endorsed by a discredited outgoing administration. After fifty years in the wilderness, the APRA socialists would probably try to sweep out everything associated with the old government, which certainly would include its pro-market, competition-enhancing reforms.

In anticipation of these developments, the November decree imposed a tight deadline for reform. It provided that CODE prepare its specifications for regulatory justifications and public comments before February 19, 1985, only three months hence. On that date, if the specifications were approved by the Council of Ministers, they would be issued in another Supreme Decree. Just before Christmas, one of the authors of this Article, Peter Schuck, flew to Lima to draft the contents of the hoped-for Supreme Decree and the necessary supporting materials. He had tried to prepare himself by reading available accounts in English of recent Peruvian political and economic developments. Upon his arrival, he was briefed by the administrative lawyers from CODE/ILD about the Peruvian regulatory structure. After further discussions, he drafted a series of documents that were intended to comprise a general legal framework for regulatory reform.

This framework consisted of four major elements: (1) a procedure for rulemaking and subsequent judicial review, essentially drawn from Section Four of the Administrative Procedure Act;³² (2) a procedure for regulatory impact analysis modeled on President Reagan's 1981 Executive Order 12291;³³ (3) a manual, to be incorporated into the Supreme Decree, that CODE would supply to the ministries to educate and guide them in preparing the regulatory analyses required under the Decree; and (4) a proposal to transform the office of the Public Minister. This office, an adjunct of the Attorney General that was statutorily designated as "the defender of the people," had long been moribund. The innovations were

31. See Roett, *supra* note 9, at 277-79.

32. 5 U.S.C. §§ 553, 702-06 (1985). These provisions authorize notice-and-comment rule making and set standards for judicial review.

33. Exec. Order No. 12,291, 3 C.F.R. 128 (1982) (requiring that agencies perform cost-benefit analysis before promulgating rules, and providing for OMB review of substance of rules), supplemented by Exec. Order No. 12,498, 50 Fed. Reg. 1036 (1985).

intended to turn the office into a kind of governmental ombudsman, advocate for the informal sector, expert commentator on regulatory proposals, and mobilizer of public opinion on behalf of regulatory reform.³⁴

Neither the American draftsman nor his eager clients expected that American institutions and methods could readily be adapted to the Peruvian political economy. The differences between the two systems were obvious and occasioned constant attention and discussion. When the documents containing the reform proposals were finally presented to De Soto and the Institute staff, they were painstakingly reviewed in a dialectical process that the participants came to call “Peruvianization.” At the most elementary level, this meant translating the documents into legal Spanish without losing—or inadvertently acquiring—important nuances in the process. Primarily, however, it meant finding techniques by which these proposals, which De Soto described as “revolutionary” for Peru, could be made to transcend the traditional boundaries of that nation’s distinctive legal, political, economic, and ideological cultures, while taking account of the realistic limits on the possibility for rapid change.

“Peruvianization” took several specific forms. First, the procedural requirements originally proposed were greatly simplified. The initial publication proposal was quite detailed, even by American standards; it involved an elaborate rulemaking and regulatory calendar procedure, a mandatory review of existing regulations, and the enlargement of CODE’s enforcement and clearance powers to approximate those (*mutatis mutandis*) of our Office of Management and Budget. This proposal was progressively stripped down. The rulemaking procedure became skeletal, the requirements for a regulatory calendar and a review of existing regulation were jettisoned altogether, and CODE’s functions were reduced essentially to exhortation and technical assistance.

Second, the proposal’s analytical requirements were substantially relaxed. During successive drafts, for example, the categories of regulatory impact information that the ministries would publish were narrowed, the obligation to quantify anticipated costs and benefits was diluted, and fewer alternatives to regulation were required to be considered. Third, the publication and analytical requirements were qualified by broad exceptions for “emergency” and “impracticability” situations. These exceptions,

34. This idea was a pastiche inspired by several American institutions: public advocate offices at the federal and state levels; governmental subsidies for “public interest group” participation in regulatory proceedings; the aborted proposal from the early 1970’s for a federal consumer protection agency; formal interventions in regulatory proceedings by pro-competition agencies such as the Justice Department’s Antitrust Division; and the auditing and investigatory functions of congressional committees and the General Accounting Office.

it was recognized, might be used by the ministries to subvert those provisions, but prudence and existing law left the drafters little choice.

Despite—or more realistically, because of—the compromises exacted by the “Peruvianization” process, the documents that CODE finally submitted to the Council of Ministers and that the Council issued as a decree on February 19, 1985,³⁵ constituted a defensible, carefully-integrated package of potentially significant reforms. The centerpiece of the package was a requirement that each ministry wishing to propose a regulation publish for public comment a regulatory analysis of the proposal. This analysis was called an “ABIP,” its acronym in Spanish. The ABIP requirement attempted to distinguish between rules that would relax existing restrictions on market activity and those that would add new or more confining ones, setting different analytic requirements for each. For “deregulating rules,” the ABIP merely had to provide “a simple explanation of the objectives expected to be achieved and the means considered to be used.”

For rules that would increase regulation, however, the ABIP had to contain a demanding analysis and justification. First, it would have to explain in detail the nature and importance of the problem necessitating regulation, describe the objectives of the proposed rule in quantitative terms, if possible, and predict what would happen if no new rule were issued. Second, the ABIP would have to discuss the means by which the rule would achieve its regulatory objective and present a detailed analysis of each of the proposed rule’s significant costs and benefits, comparing them with the status quo and using quantitative estimates, if available. This analysis would discuss “all significant factors,” including the rule’s effect on the formal sector, on the informal sector, and on small-scale companies and their access to the legal economy, its effect on low-income consumers, the administrative burdens it would impose on firms and public agencies, and its overall effect on economic efficiency. Third, the ABIP had to include consideration of “one or more less restrictive alternatives” to the proposed rule and, for each such alternative, conduct the same kind of cost-benefit analysis as that done on the rule itself. Further, the Decree required an explanation of the reasons for rejecting each alternative.

The February Decree included two documents in addition to the ABIP requirement. CODE’s guidelines for the preparation of ABIPs contained a detailed explanation of the purposes and methodology of ABIPs, the criteria for the required analysis, and a standardized ABIP form. CODE’s guidelines for the conduct of public hearings, which it recommended and, in some circumstances, required, created another means by which ministries could elicit public comments on proposed regulations. In

35. Spanish version on file with the *Yale Journal on Regulation*.

addition, CODE, with the help of a co-author of this Article, Robert Litan, prepared several “model” ABIPs on new regulatory proposals, circulated these to the ministries as a way of demonstrating the feasibility and value of the technique and provided other kinds of ABIP-related technical assistance to ministerial staffs.

The regulatory reform initiative embedded in the February decree was an extremely far-reaching overhaul of the Peruvian system. In a state that seemed to churn out new anti-competitive regulations without significant constraint, these new legal structures were intended to democratize and rationalize regulatory intervention. For the first time, mechanisms were created to bring the interests of the informal sector, small-scale enterprise, and low-income consumers systematically to the forefront of bureaucratic consciousness. Indeed, the new ABIP process was in some ways even more ambitious than the regulatory system in the United States. For example, despite urgings by the authors of this Article that the analytic requirements be limited to major rules alone, as they are in the United States,³⁶ the Institute’s final version of the plan contemplated cost-benefit analysis of virtually all rules affecting the private sector. The Institute’s logic was that publication, even if it accomplished nothing else, would at least loosen the regulatory bottleneck. Moreover, the Public Minister, whom De Soto knew to be sympathetic, would be well-positioned to act as a politically and technically sophisticated in-house advocate for the informal sector. To the authors’ knowledge, no similar package of reforms had ever been instituted in a developing country.³⁷ If it succeeded, it could send enormous ripples throughout the Third World.

De Soto and his American advisors fully expected that such radical (if sensible) institutional innovations would encounter stout bureaucratic resistance from regulators, as has often occurred in the United States. In anticipation of opposition, they prepared to enlist the support of various private sector interests to bring pressure on the relevant ministries to adhere to the ABIP requirements. The Institute intended to help the ministries prepare ABIPs and to assist private interests affected by regulatory proposals in preparing their comments. All this activity, which would be conducted behind the scenes, was designed to advance the regulatory reforms that the Institute desired.

36. See Exec. Order No. 12,291, *supra* note 33.

37. It is true that a package of market-oriented reforms was introduced in Chile in the 1970’s on the advice of economists from the University of Chicago, most notably Milton Friedman. See P. O’BRIEN & J. RODDICK, CHILE: THE PINOCHET DECADE (1983). Those reforms consisted primarily of liberalizing trade barriers and restricting monetary growth to control inflation. In contrast, the reforms championed by the ILD are microeconomic in nature, focusing on domestic deregulation and securing individual rights of property, contract and business organization in an effort to facilitate market transactions.

Unfortunately, events did not transpire as De Soto and his colleagues at the Institute had hoped. Neither the Peruvian government nor the bureaucracy was prepared to accept such a significant alteration of the legal landscape without a struggle. With the Presidential elections only eight weeks away, the political timing could not have been less propitious. A few regulators, particularly in the economically important Fisheries Ministry from which several CODE lawyers had been recruited, initially complied with the new Supreme Decree by publishing rules and preparing ABIPs with the aid of CODE and the Institute. Most, however, simply ignored the new rules, confident that the outgoing President's interests lay elsewhere and that time was on their side.

The Supreme Decree also generated a desultory response from the formal Peruvian business community. Various trade associations initially expressed some interest in the reform package, giving De Soto and his staff opportunities to present and discuss the implications of the ABIP and public comment requirements. But, correctly sensing that they were themselves potential targets of the Institute's proposals, the associations did little thereafter to support the new initiatives. De Soto anticipated this reaction. After all, the revolution he hoped to instigate sought to destroy the mercantilist tradition that he felt had brought Peru its current woes.

In the face of this widespread recalcitrance on the part of regulators and the business community, the Institute altered its original strategy. In doing so, it managed to turn what could have been a crushing defeat into a significant advance by taking advantage of support from the press, the one sector of Peruvian society that backed the reforms. Shortly after the national elections, the municipality of Lima issued a new decree imposing a tight system of regulation on the city street vendors. Though the requirements of the February decree did not pertain to municipal regulation, the Institute seized the opportunity created by the new street vendor ordinance to demonstrate the powerful use to which cost-benefit techniques could be put. The Institute prepared its own ABIP of the new rule and published it as a full-page advertisement in all of the major newspapers in the city. The advertisement pointed out how the costs of the street vendor ordinance 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 advertisement generated an immediate and dramatic response. Organizations of street vendors, existing and new, protested the new rule. Several city newspapers criticized it in their editorials. Newspapers, magazines, and television continued to report the controversy, putting pressure on the municipality to reconsider its regulatory decision. This

adverse publicity and public pressure in opposition to the ordinance would never have arisen without the Institute's initiative.

The Institute continued to engage in similar activities. In May, 1985, a major Peruvian weekly magazine, *Caretas*, agreed to publish articles prepared by the Institute on the relationship between regulation and the informal sector. The Institute has continued to write articles for *Caretas*, educating the public about informality generally and about specific areas of excessive or inappropriate regulation, particularly in the housing and transportation sectors.

Although the Institute's "private sector" strategy did not initially have the success that it hoped for, the strategy slowly gathered momentum. Immediately after CODE was created, the Institute brought the ill effects of two regulatory proposals to the attention of two important constituencies: restaurant owners and the fishing industry trade association. Neither group was able to block or change the proposals; indeed, neither seemed very interested. The Institute was somewhat more effective in late 1985 and early 1986 when it mobilized the municipal bus drivers' union in Lima against a proposal by the municipal government to use bus drivers as tax collectors in a new transportation tax system. Although the proposal was eventually implemented, the Institute's work against the proposal attracted considerable notice in the city and built support for its activities among a large organized workforce.

Limited success for the Institute came in the spring of 1986 when it persuaded the Garcia government to direct the Public Minister to exercise his ombudsman-like responsibilities by receiving citizen complaints about the government and bringing them to the attention of the proper ministries. The Institute had previously urged this step on the Belaunde government but had failed; by 1986, however, the timing for such a reform had improved. Garcia himself had made some gestures toward the informal sector in his first six months in office, promising to rectify the unequal distribution of wealth that he claimed had victimized the informal sector. An active Public Minister might be an attractive element in his overall strategy.

De Soto quickly took advantage of the new ombudsman process to advance a major element of the Institute's reform agenda: housing reform for residents of the *pueblos jovenes*. Immediately after the Public Minister began his "defender of the people" role, the Institute helped to orchestrate a flood of complaints from groups representing over 300,000 people who could not readily secure title to their make-shift residences. The Institute cited these complaints when it urged the government to streamline the extremely cumbersome bureaucratic process for obtaining title. The Institute's campaign clearly struck a political nerve. The prospect of granting

title to millions of Peruvians encouraged President Garcia quickly to seize the issue and make it his own. In April, he made a well-publicized visit to the *pueblos jovenes* and announced a titling law that was immediately approved by the lower house of Peru's legislature.

Although De Soto and the Institute publicly congratulated Garcia for responding to the Public Minister's campaign, they were not completely satisfied. They felt that the measures failed to topple the bureaucratic obstacles that the Institute had targeted. In addition, the new law would grant imperfect titles that prohibited rentals and restricted the rights of owners to resell their properties. Eventually, after hearing testimony from De Soto, the Senate Committee charged with revising Garcia's proposal incorporated several of the Institute's recommendations in its version of the titling law and requested the Institute's assistance in drafting more comprehensive housing legislation in the future.

The Institute is currently seeking to capitalize on the public attention that its housing reform efforts attracted. Through expanded media exposure, it hopes to persuade the government and the public of the regressive effects of excessive regulation. Perhaps even more importantly in the long run, De Soto hopes to convince the informals that they have a strong common interest in fighting excessive regulation through political action. Once assembled and mobilized, De Soto believes, this constituency of informals, with allies in the media and formal sector, may succeed in motivating Peru's leaders to adopt the legal reforms necessary to integrate the country's two economies, thereby laying a solid foundation for future national growth.

The Institute also hopes to inspire similar efforts in other Latin American countries that have significant informal sectors. In 1985 De Soto spread his message to a conference on micro-enterprise in Latin America held in Mexico City and thereafter met with individuals from Brazil, El Salvador, and Venezuela who were interested in establishing research organizations in those countries modeled on the Institute.

Conclusion

It would be gratifying to conclude this account on a note of optimism. We would like to report that significant progress has been made and gains consolidated, that Peru is firmly on a path toward improved economic efficiency, more equitable distribution of income, greater scope for small enterprise, and rational, accountable regulation. Unfortunately, we cannot. Five years after the Institute began its extraordinary crusade for fundamental changes in the economic, legal, and regulatory systems of Peru, the nation's economic future remains bleak. Although it has awakened the

Peruvian government to the plight of the informal sector, the Institute's reform program has thus far failed to take firm institutional root in Peru's inhospitable political culture.

Certainly the Institute's difficulties do not stem from want of effort, skill, or imagination. Although reformist enterprises of this sort may seem numbingly familiar to media-weary Americans, nothing quite like them has ever occurred before in Peru or, apparently, anywhere in the Third World. The Institute's energetic investigation and documentation of the informal sector and of the conditions that have promoted and sustained it is a model of policy-oriented, reformist reportage accomplished under the most severe constraints. De Soto's ability to use those findings in a politically creative way has been impressive. He won a place on a national policy agenda that had long been crowded and misshapen by constant economic and political turmoil. In the name of property rights, he challenged the dominant socialist ideology at a time when it was rising to the zenith of its power in Peru. Moreover, he not only articulated a competing ideology of property rights, but also managed to reify it (however briefly) in legal decrees, in specific guidance to administrative bodies, and in the design of governmental institutions. De Soto's program thus provides an enduring ideal to which Peruvians may perhaps turn when they are weary of the country's present, almost certainly futile course. Even so, that moment of vindication seems distant today. For now, at least, De Soto remains one voice crying out in the Peruvian wilderness. His program of property rights, administrative law, regulatory reform, and advocacy for the informal sector seems politically anachronistic in an era marked by APRA's triumphant accession to power and its strategic need to discredit what preceded it.

The first lesson to be learned from this experience, then, is that in the politics of economic reform, timing is everything. Had the Institute started its work several years earlier, it would have had more time to prepare the soil in which the seeds were sown; had it been able to nurture its fragile creations slowly and carefully until they were sturdy enough to defend themselves, its efforts might have been more fruitful. Had the new regime been more self-confident and less determined to uproot whatever its predecessor had cultivated, the Institute might have had more breathing space in which to demonstrate the value of its program and institutionalize its reforms. Had Peru's political and economic condition been somewhat less turbulent, more public attention might have been paid to the Institute's proposals.

Crisis also creates political opportunity—our second lesson—and De Soto was quick to exploit it. It was not inevitable then, nor is it inevitable even today, that Peru's agony would lead it to reject property rights,

regulatory reform, and the liberation of the informal sector as remedies for its chronic economic problems. We do not claim that the Institute's policy agenda necessarily contains the answer to Peru's current economic difficulties, but we have little doubt that De Soto and his colleagues are on to something important. A legal system that discourages the formation of efficient business enterprises cannot help but inhibit economic growth. Similarly, a legal system that fails to guarantee fundamental rights of property, contract, and business organization must discourage entrepreneurs from innovating and investing to increase production and develop new markets. Consumers and workers will inevitably suffer from these disincentives.

Private markets, of course, are not perfect either and can generate significant social costs. Once unleashed, powerful entrepreneurial forces can introduce profound cultural and aesthetic changes as competitive, materialistic values destabilize social arrangements built upon values that are traditional, solidaristic, and often religious. Fearing such changes, Peru could rationally choose to tolerate a smaller role for market institutions and values than we in the United States might wish for ourselves or for others. At a minimum, however, De Soto's efforts suggest that greater attention should be paid to the damage that Peru's regulatory system seems to be wreaking on its economic performance.

We recognize that it is difficult to quantify these effects. Much additional research of the kind the Institute is now undertaking will be needed to estimate the increase in formal sector investment that would result if informal entrepreneurs were given access to formal credit and rights of property, contract, and business organization. Neither do we know how much informal entrepreneurs would expand the scale of their operations if they did not fear detection and punishment for operating without necessary licenses. These quantification problems are compounded by the interactions among the Peruvian economy's other anti-competitive features. Limited property and contract right protection, for example, not only discourages informal entrepreneurs from expanding their activities but also denies them access to less expensive credit at formal lending institutions, which further discourages expansion. Interest rate controls not only lead to credit rationing in favor of formal entrepreneurs but also discourage domestic savings and encourage capital flight, which harm both the informal and formal sectors. Because these effects are widespread in Peru, its economic policy-makers cannot safely ignore them.

Our experience in Peru teaches a third lesson, namely that important links exist among informal activity, economic growth, corruption, regulatory rationality and accountability, and the legal system. As Peru's experience demonstrates, the law's propensity to define and protect property

rights, secure citizen access to the regulatory process, require analysis and justification of rules, and encourage enterprise can hardly be taken for granted. These virtues are highly contingent on ideological and institutional commitments that Peru has been manifestly unwilling to make. Unless Peru is prepared to alter the underlying rules of the game in this direction, significant improvement in its long-term economic performance is unlikely. In an integrated world economy increasingly characterized by intense competition and convulsive change, Peru's form of mercantilism is a self-destructive strategy.

A fourth lesson concerns the danger of what one might call "intellectual imperialism." As students of past domestic and foreign policy reform initiatives, the authors were well-acquainted with the tendency of reformers to underestimate the controversiality of their value assumptions and policy goals and to neglect the cultural, institutional, and political obstacles to implementation of their proposals. As visitors in an alien culture, we were reasonably sensitive both to the distinctiveness of the American experience and to our abject ignorance of Peruvian ways. The attempts at "Peruvianization" were intended to help avoid the most serious risks of ethnocentric distortion, but the shortness of time ensured that even these precautions would not enable us to shed our premises wholly or to understand theirs fully. In particular, our deeply-embedded assumptions about cultural and institutional constraints on governmental power, so prominent in American life and so weak in Peru, proved difficult to abandon. Our frantic search for mechanisms to enforce the proposed reforms—courts, media, public interest groups, individualistic ethos, ombudsmen, *anything*—may have been resourceful, but in the Peruvian context was largely irrelevant. In the end the best safeguard against this kind of political hubris is a reformer like De Soto who has a sophisticated, realistic conception of what his country is and what it might become.

Our final lesson is captured in Max Weber's description of politics as "a strong and slow boring of hard boards."³⁸ Implementing fundamental reforms in a Third World political economy like Peru's is an exceedingly difficult, laborious process. At a minimum, such innovations must be sponsored at the very highest levels of government to ensure that they are placed prominently on the public agenda. In addition, new coalitions must be mobilized, consisting of political entrepreneurs like De Soto, groups of informals, reform-minded regulators, and formal sector firms with a stake in strengthening competition. These coalitions must educate and influence

38. M. WEBER, *Politics as a Vocation*, in FROM MAX WEBER: ESSAYS IN SOCIOLOGY 128 (H. Gerth & C. Mills ed. 1958).

the public and politicians and also exploit newly-created opportunities to participate actively in the shaping of regulatory policy.

In some societies, especially those unlike our own in which the government possesses effective centralized power, fundamental policy shifts of this kind can sometimes be accomplished quickly if they are endorsed by the small number of significant power holders. This political insight governed De Soto's initial strategy. But he did not fully appreciate until it was too late that even with such elite endorsements, fundamental reforms may flounder if they are pushed too fast, or only from the center. De Soto's program has yet to attain the success that had been sought because it was too ambitious, even with "Peruvianization," and too much in a hurry, despite five years of hard work. His program stepped on too many bureaucratic toes before De Soto had an opportunity to build a strong popular constituency for change. In a sense, our effort was a classic example of "top-down" reform: a program of policy innovation that concentrated on persuading the Council of Ministers rather than on generating grass roots pressure and winning support at the lower levels of the bureaucracy where policy is actually implemented. The experience of regulatory reform in Peru suggests that, although this approach may be a perfectly natural and perhaps indispensable tactic, it is not sufficient.

De Soto and his colleagues appear to have learned this last lesson. The Institute is now beginning to generate significant support within the informal sector for some of its reform proposals. But a long uphill struggle remains in a society in which the mountainous mercantilist terrain may simply be too steep for any lone innovator to conquer.