

Making the “Extralegal” Legal

by Nafisul Islam

In the early 1980s, Hernando de Soto, a successful businessman and economist, left Europe to visit his native Peru. During his trip, he was struck by the disparity between the vibrant entrepreneurial spirit of the people and their desperate poverty. To find the reason for this gap between motivation and result, he decided to open a small garment factory in Lima. His first step was to hire four university students who would complete the bureaucratic procedures necessary to obtain a business license. After 289 days and a cost 32 times the average monthly minimum wage, they received the license. This experiment convinced de Soto that it was expensive and time-consuming bureaucratic procedures that kept people out of formal markets and in the informal sector. To investigate this problem in more depth, and hoping to find a solution, de Soto founded a think tank, the Institute for Liberty and Democracy (ILD).

From 1981 to 1984, de Soto and his small research team at ILD talked to the poor in Peru’s shantytowns and compiled figures describing their businesses. The numbers confirmed a prevalence of economic informality in Peru. Fifty-six percent of all business, 86 percent of the bus service, and 60 percent of grocery retail in Peru were carried out in the “extralegal” sector. “Peru had become two nations – one where the legal system bestowed privileges on a select few, and another where the majority of the Peruvian people lived and worked outside the law, according to their own local arrangements.”¹

People conducted business outside the law because the bureaucratic regulations made it impossible to operate within it. As a result, they were denied opportunities to invest in businesses and participate in the formal economy. Even those people with thoughts of entrepreneurship could not trade beyond a circle of people who knew and trusted them.

De Soto came to realize that it was also the absence of formal property rights that explained why “people who have adopted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.”² He believed that people could be empowered by using their existing assets to benefit themselves and their communities. The poor of Peru possessed urban land and housing worth \$17 billion, but a majority of the people who possessed these assets did not have the legal titles to them. Consequently, people were not able to use their homes as collateral to obtain loans for business development. “Without a title, there is no way to build a system of securitization that gives them access to credit or water, telephones or electricity,” said de Soto.³ ILD estimated that in 1989 the poor in Peru held \$80 billion in untitled assets, assets that de Soto dubbed “dead capital” because they could not be invested to create new wealth.

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-Hernando de Soto

Partnership for Advocacy and Legislative Reform

The first ever partnership of the Center for International Private Enterprise (CIPE), and one of its most successful, was with ILD. Beginning in 1984, CIPE helped ILD design an economic reform agenda and an advocacy campaign based on increased citizen participation in decision making. ILD used “289 days” – the time required to legally create a small business – as its slogan in order to convey the scope of the administrative barriers and legal discrimination experienced by small-scale entrepreneurs. Through advocacy and communications activities, ILD established working relations with many informal sector groups that became strong advocates for ILD’s legislative proposals. The research and proposals of ILD also found support among government officials who represented a broad range of political parties at the municipal and national levels.

In 1986 de Soto published *The Other Path: The Invisible Revolution in the Third World*, which offered the poor an alternative to revolution: entrepreneurship. The title of the book and its

policy prescriptions were a direct challenge to the vision of Peru's violent Shining Path insurgency. De Soto identified weak institutions as the primary barrier to entrepreneurial growth and highlighted the importance to development of institutions such as contract law, financial markets, and the judicial system. The book became a bestseller and was translated into twenty languages. The following year, de Soto introduced his ideas to multilateral organizations and reformers at the first international conference on the informal sector, organized by CIPE.

As part of its advocacy program, ILD drafted its own cost-benefit analyses of economic issues, which were published in various magazines with a combined readership of around 1.2 million Peruvians. These analyses covered topics such as access to credit, land titling, simplification of administrative procedures, and access to public information. The papers also included ILD's easily understandable proposals for legislative alternatives in these areas.

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ILD created an ombudsman's office, the *Balcon de Todos* (Balcony for All), in order to institutionalize direct access to lawmakers. The office received complaints, motions, and suggestions from citizens regarding the legal and bureaucratic problems they faced, and referred these to the attorney general's office. ILD researched the complaints, prepared economic and legal analyses, and proposed laws as solutions. This consultative program represented ILD's willingness to take initiative in setting a legislative agenda that would benefit a majority of Peru's citizens.

ILD was instrumental in drafting and advocating new legislation throughout the late 1980s. Peru's Administrative Simplification Law was approved by the Peruvian Congress in 1989 as a direct result of ILD's research and public advocacy efforts to simplify, reduce, and eliminate lengthy governmental bureaucratic procedures. ILD's recommendations that were included within the law ranged from reducing passport and

import registration fees to simplifying requirements for receiving retirement benefits. Another law drafted by ILD and enacted in 1988 was the Popular Mortgage Law. The law was designed to provide access to credit for informal landowners, who had previously received a mere 0.4 percent of the credit available from banks. The new law enabled Peruvians to obtain titles to their homes and thereby the ability to use their homes as collateral for a bank loan at market interest rates. Following the law's approval, ILD provided assistance to the government to ensure the proper administration of the law. ILD also helped draft regulations to be included in a new Property Rights Law, and created a property registry suited to the circumstances of landholders in shantytowns.

Success at Home for a Model Abroad

ILD has achieved tremendous results not only in Peru, but has also spurred reforms in countries as diverse as Brazil, China, and Thailand. Hernando de Soto has convinced numerous heads of state to implement institutional reforms, and many NGOs and think tanks have adopted ILD's approach to reform and advocacy.

As a result of ILD's domestic efforts, 300,000 small enterprises were integrated into Peru's formal economy, accounting for 560,000 legal jobs and contributing an added \$300 million in tax revenue. Moreover, the time needed to legally register a business was cut from about 300 days to less than one day. "After six years of listening to the poor, the ILD was actually in a position to help them," said de Soto. "We put into place all the legislation and mechanisms required to bring into the law most extralegal real estate and businesses."⁴

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Notes

¹ Jeremy Clift, "Hearing the Dogs Bark," *Finance & Development* 40:4, International Monetary Fund (Dec. 1, 2003).

² Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), p. 7.

³ “An Interview with Hernando de Soto,” *Economic Reform Today* 1 (1996).

⁴ Hernando de Soto, *The Other Path: The Economic Answer to Terrorism* (New York: Basic Books, 1989), xxvi.

Sources

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Peter F. Schaefer, “De Soto’s Different Path,” *Washington Post* (Jan. 27, 1991).