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1
Informality and Unreality

Any person ought to have the right to enjoy the fruits of his own work.

– David Hume

Informal markets permeate economies worldwide. Informality coexists with formal market structures in developing and developed countries alike, making assets illiquid and locking up potential profits. What does informality look like? It has a very human face. Picture Latin America, where farmers sell produce on a side street without a license. Picture Europe where new, often undocumented immigrants hawk items at outdoor bazaars or at street intersections in large cities whenever traffic is stopped. Picture New York City, where drivers without a hackney license use their own cars as taxis after finishing their "regular" job. Picture "transaction middle men," ubiquitous in Latin America, where they usually are referred to by the elegant Spanish name of *tramitadores,* who are hired by wealthier citizens for help with seemingly simple tasks such as renewing a passport or obtaining a government license. Picture New Orleans, where some residents reportedly refused to leave their homes after hurricane Katrina hit in the fall of 2005 because they did not have official documentation

proving their ownership. Many transactions to transfer, buy or sell properties in the city were not registered but kept in personal notarized contracts, which were in danger of being lost in the floodwaters.

Informality is social and economic behavior or conduct under rules recognized only among the members of a community – and it has consequences. In informal markets, people have marketable assets that are not properly licensed or registered, and they also buy, sell, own or lease real estate without registering the transaction. In a market setting, informality prevents individuals from enforcing or defending their rights and excludes their labor and assets from formal transactions. The result is that the value for their work and property is set at a lower level than what their "true" value would be in a formal market.

The concept of informality can be difficult to understand, particularly for those who live and work in the developed world, and even for some of those who live and work within the formal structures of developing economies that also have parallel informal markets. It can seem naive, foreign, irrational and marginal. It can even appear folkloric.

For many, participation in informal markets is not a choice, but a reflection of the absence of choice. It is a pragmatic survival mechanism for those excluded from formal markets by a lack of information and prohibitively high costs, two factors which also can quickly squeeze individuals out of formal markets they struggled to enter. Exclusion is a key element of informality. This soon leads to a situation in which formal and informal markets exist in parallel, but with stunted profits in both, and forces the creation of alternative enforcement mechanisms for informal systems and transactions, because participants in these markets cannot rely on formal avenues of redress.

In the aggregate, informality wastes resources and imposes far greater costs than providing equal access for all to formal markets. These costs are borne by the individual and society as a whole. The cost of informal markets is found in the difficulty of enforcing rights over labor and assets, which makes employment precarious, raises transactions costs and lowers asset values.[1] Formal institutions have a better track record of reducing transactions costs than do informal institutions, which explains in part why assets tend to be more valuable in formal than in informal markets.

As pervasive as it is, informality is difficult to quantify. Consider, though, one attempt to gauge its impact on property. According to an estimate by de Soto, the worldwide cost of construction materials locked in buildings that are considered "informal" and hence illiquid, is $9.3 trillion, which de Soto explains is "nearly as much as the total value of all the companies listed on the main stock exchanges of the world's twenty most developed countries."[2]

Informality and Illegality

Often, informality in markets is equated with illegality, which is not always the case. While informality takes place beyond the confines of the law, the "informal way" is not necessarily against or in violation of the law. To be informal does not necessarily mean one is illegal, or vice versa.

There are clear distinctions. Informal markets arise when formal rules are overly restrictive, unclear, unpredictable or costly to follow. Illegality, however, most times includes an element of intent. If one were to cheat the system and register the wrong property in one's name, or fake a title of ownership, that would be illegal.

Informality is very prominent in property and labor markets. When Rita, a seamstress supporting her family, decided to register her small home, she later discovered, to her surprise, that she had embarked on a multi-year marathon. Although Rita has lived in the house for years and dutifully paid

Informality and Illegality – *continued*

her property taxes, she found that the institutional structure made it almost impossible to move into the formal world. Rules that were confusing to begin with changed and she was forced to start over. Then, she was told that she had been violating the rules and faced a fine. Without the luxury of time and money to hire lawyers, go to court and hope to resolve the matter, Rita had no choice but to remain in the informal environment. Instead, like many of her neighbors, she decided to continue to rely on property tax receipts as her "official" proof of ownership.

When José, a day worker of limited means wanted to start a taxi service, he spent months collecting the requisite papers to obtain a taxi license. After repeatedly going back and forth to the license office, an official refused to accept his application. The problem? A discrepancy in the names on his documents. The accent mark was omitted from his name on his identity card, making it slightly different from the name on his driver's license. José was faced with having to petition the civil registry to correct the mistake on his identity card, a time-consuming process that would probably defer his dream by at least a year. His two other options: Bribe the official to overlook the discrepancy and accelerate the process of getting licensed, or forgo the license and instead get a large sheet of paper, write "TAXI" in bold, black letters, and stick it on the front window of his car. We leave you to guess which he chose.

Why are informal markets more prevalent in some countries than in others?

All too commonly, people consider informality to be some sort of cultural phenomenon. We hear informal market behavior characterized, for instance, as the "black market." Those in the formal world often view those who engage in informal markets as having a negative mindset. They may take a facile view of this informal part of the world as a place where people live with values that breed informality. People may see the gap between formal and informal markets as signs of a gap based on race or geography, black versus white, or North versus South. Informality may be described as a "Latin" phenomenon, or an "African" phenomenon, or

Asymmetric Information and Moral Hazard Behavior

Information known to some is often unknown to others. The seller of a used car generally has more information about the vehicle than the buyer; for example he may have been the driver in an accident that required rebuilding the entire rear end of the car. The buyer, though, only knows what he is told or is able to find out by inspecting the vehicle before the purchase.[3] This asymmetry of information distorts market participation and market prices as the seller can price the car above the level the buyer would be willing to pay had he had complete information. Obviously, buyers of used cars are not the only ones suffering from incomplete, one-sided information. In fact, asymmetric information can be a serious issue when it is widespread and affects markets across the board and eventually decision-making.

Information asymmetry is frequently accompanied by another problem which economists refer to as moral hazard behavior. Broadly speaking, moral hazard describes a situation in which a party to a contractual relationship, a single person or a group of persons, behaves opportunistically and can affect the outcome of this relationship to its own advantage.[4] Moral hazard behavior usually develops when individuals know that the benefit they expect outweighs any possible negative consequences. For instance, people who have more information than others may have less incentive to share their insights if they wish to use this knowledge for their own private gain.

With regard to informality, asymmetry of information keeps some people who do not have access to all the information necessary to participate in the formal market from enjoying the full benefit of their marketable assets. At the same time, a small privileged elite who does have access to crucial resources has the incentive (moral hazard) to block information flow or even misinform others in order to preserve the status quo which is beneficial to them.

just "the way *they* do things." From this perspective, it is a very small leap to conclude that even corruption – a byproduct of informality, one might argue – is part of the social fabric and built into the "social DNA" of these societies and their people.

High transactions costs are evidence of informality and act as barriers to entry. The process of completing one transaction may entail many bureaucratic require-

ments and continuous demands from officials at any stage of the process for clearances, inspections, documents or witnesses. Sometimes the demands are legitimate and expected; some other times they are unexpected and created on the spot by some official. People – such as Rita or José – often cannot see the end point of a transaction they engage in and determine whether it is worth pursuing without first incurring its exorbitant costs. Transactions costs lead to a limited number of formal players and asymmetry of information. As a result, policy and market decisions tend to be based on information provided by these few formal players and only apply to them, which further distorts values and prices. A vicious circle develops; high transactions costs protect the beneficiaries of the system who can influence policies so as to maintain transaction costs – and thus barriers to entry – high.

If this sounds complicated, it is! The implications of informality have investors view informal markets as risky and unpredictable, making participation in them unattractive. Consequently, private investment into such markets, if any, is confined to small lines of credit or microfinance, usually backed by government guarantees.

As we will see in Chapter 2, informality often springs from abrupt shocks in a country's historical development, such as wars, colonization or occupation, and is hatched by rigid institutions that can be found, for example, in countries with a strong mercantilist tradition.[5] Informality tends to thrive in these types of economies, typically closed to outside influences, or in seemingly open economies where it is well-hidden in the wrinkles of regulated market segments. Thus, informality is not a phenomenon created overnight, but one with deep historical roots. Ultimately, countries with excessive regulation keep their markets working by limiting participation in the formal economy to a small elite. Just as in

the centuries-old mercantile world, where Kings, nobles, merchants and priests constituted their own elite, such economies operate as a "members only" club, deriving legitimacy from a privileged group that has both monopoly power and, obviously, an interest in preserving the *status quo*.[6] These economies, although very inefficient, do survive as long as they limit market transactions and keep themselves highly regulated and as closed as possible.

The role of history

When I traveled to Peru in the early 1990s, I was surprised to find remnants of mercantilism still powerful in pockets of the economy and among the elites who sought to guide policy making and control most natural resources and economic activity, including land transactions. Mercantilism was the economic philosophy of the sixteenth, seventeenth and eighteenth centuries in Europe, where the state was expected to be strong and the key players had clearly defined roles in the economy. Kings controlled money and security, nobles controlled agriculture, merchants controlled trade, priests controlled morality and behavior and the serfs served as the labor force.[7] Trade, land and mining were highly regulated and transactions were valued and paid in precious metals. Mercantilists identified these assets with wealth and viewed the economy as a zero sum game in which a gain by one party was a loss by another.

Studying Peru's history and especially the sequence of the country's ruling patterns helped me understand what I had experienced during my visits. The Spanish in America brought a strong mercantilist culture to their colonies in the New World. After exploiting the mines of Mexico and Peru, Spanish colonizers turned to

the land and aimed to recreate the great estates of the Castilian nobility in Spain. Spanish colonial societies were based on institutions that mirrored those in Spain. The Council of the Indies, the chief administrative body for Spanish colonial affairs, took the place of the King and nobles, advised the crown on colonial legislation and served as an appellate court for decisions by Spanish commercial interests.[8] It became the model of all colonial organizations and even in the nineteenth and twentieth centuries, the governments of former Spanish colonies in South America were staffed by the same mercantilist players – lawyers, nobles and old colonial hands – who kept creating organizations based on the colonial models. These organizations were awash in red tape and invariably adopted special regulations when problems arose, an approach that guaranteed plenty of work for lawyers and lawmakers.

Mercantilism's Long Reach

Mercantilism may be thought of as a doctrine followed by a collection of economic policies designed to keep the state strong and prosperous through extensive economic regulation and rigid bureaucracy. Countries with mercantile economies applied very strict rules on foreign trade; aimed at ensuring that the country exported more than it imported. Merchants and governments benefited greatly from this system, which restricted foreign competition and protected domestic monopolies, while it brought high tariffs into the public treasury.

Adam Smith challenged this philosophy in his 1776 work *The Wealth of Nations*, charging that mercantilism created massive economic inefficiencies and benefited producers at the expense of consumers. Smith offered a radically different notion that wealth consists of all the goods that all members of a society consume, a modern and very democratic concept that was starkly at odds with the mercantilist model. John Locke and David Hume also challenged mercantilism in their own writings. But it was in the mercantilist era when Europeans first appeared in the New World, and their colonies tended to copy what existed in Europe.

Institutions, organizations and property rights

To understand fully the problem of informality, its historical roots offer only a starting point. We also need to grasp the fundamental difference between the concepts of institutions and organizations. This difference is essential as it allows for a proper evaluation of informality and an identification of any necessary changes to institutions or organizations to overcome the problem. Whereas poorly defined institutions can create informality, this is not necessarily the case when organizations are malfunctioning. However, the two concepts are usually confounded, especially by those charged with fixing one or the other.

Institutions are the natural dynamics of society. They are a set of rules, norms and traditions, some written and some not, some formal and some informal. Institutions "structure incentives in human exchange, whether political, social or economic."[9] In other words, they hold together and protect the social contract[10] by enforcing contracts and laws and providing a sense of certainty in human exchange. As Nobel laureate economic historian Douglass C. North explains, institutions "are the rules of the game in society or, more formally, are the humanly devised constraints that shape human interaction."[11] Formal institutions can be, but not always, written; they are found in laws – such as the Constitution, Civil Code – and regulations, contracts and administrative procedures. Conversely, informal institutions can be described as norms and values commonly accepted by society, including behavioral expectations. Organizations, while related to institutions, are the tools through which institutions function, sometimes smoothly and sometimes poorly. They can be agencies, ministries, departments. In human terms, they are the actors that pursue common objectives shaped by institutions.

We find a simple illustration of the difference between the two in the area of justice, which is an institution that encompasses the written and unwritten rules, informal traditions and incentives that define just behavior and conflict resolution. By contrast, a government's Ministry of Justice, Judiciary and Courts charged with applying laws are organizations.

Formal markets are guided by institutional structures that establish and ensure a kind of partnership between citizens and the state through which resources are allocated efficiently and transactions are secured, thus reducing uncertainty. All citizens in such markets ought to enjoy the right to share in the resulting benefits from institutions, including social cohesion and profits. The main type of institution is property rights;[12] that is, the right to possess, enjoy and use any asset, including land, movable property, and proprietary ideas to mention a few. The smooth functioning of a formal market depends on the ways in which property rights are defined, applied and enforced.

In this book, one type of property figures prominently – real estate. It is an area where policymakers frequently collapse the notions of institutions and organizations. Property is often viewed simply as land, housing, or shelter with a narrow, specific use, rather than a fully tradable asset with potentially multiple economic and financial uses that increase its value. As a legal term, "real estate" typically encompasses land and anything affixed to it, such as buildings. One may own a home or have money invested in an office or apartment building that rents to tenants. "Real property" is usually distinguished from personal or movable property, such as books or machinery. In countries governed by common law, the terms "real estate" and "real property" are typically used, while countries governed by civil law usually refer to "immovable property."

At first, informal markets might not appear to be part of an institutional structure because of a tendency to associate "institutions" with "formal" rules and structures. In fact, informality stems from the same rules and norms of human behavior represented by formal institutions. Organizations can reinforce informality by the way they apply formal rules of institutions. While in theory, the institution of property rights allows property rights holders to trade any type of property, many organizations may not fulfill their responsibilities in a way that allows for such rights to be exercised fully. The judiciary, the registry, the patent office or the licensing bureau may all reinforce, perhaps inadvertently, the conditions that perpetuate an informal market. As we shall see later, knowing how to apply the distinction between institutions and organizations is critical to the successful development and implementation of policies that can transform informal markets to formal ones and unlock property values in the process.

Institutions and their organizations ought to reflect society's demands at all times. When they do not, exclusion and informality arise as exchanges take place outside the formal rules and organizations. Formal institutions and the organizations associated with them are rarely flexible enough to adapt to the informal norms of behavior, refusing even to recognize informal social and market conduct. Ironically, this exclusion perpetuates informal behavior and further exclusion. Separate sets of rules, formal and informal, create two economic and social languages in the same country.

"Unreal Estate"

Sadly, the situation faced by people forced to conduct their transactions in informal markets suggests that their property is anything but "real." In a very true sense,

their assets are locked and to the degree that these people own any property, it might be called unreal estate.

The queen who cannot get a formal bank loan illustrates the problem brilliantly. "La Reina de la Papa" ("The Potato Queen"), a 45-year-old Peruvian potato merchant, lives in a ramshackle settlement on the outskirts of Lima, Peru. Famous throughout her neighborhood for her commercial acumen, the business she runs from her home, a clearinghouse for local potato producers, is a flourishing one. She also imports potatoes from neighboring Bolivia when the local crop is in short supply. La Reina manages potato distribution to many open-air markets that crowd Peru's city squares, playing a vital role in helping to ensure a steady supply of a staple of the Peruvian diet. Her outstanding business network has earned her a healthy profit and considerable respect.

Although clearly she is alive and well – albeit less aristocratic than her title might imply – La Reina does not appear as a business or property owner in any of the official records of Peru, leaving her almost no recourse to leverage her assets. She faces volatility and cash flow challenges and she is unable to expand operations to meet growing market demand, or hedge her business because she cannot formally pledge future earnings or assets – for example, her home and warehouse – as collateral.

La Reina's predicament is neither an accident nor the result of an oversight. No one forgot to include her business in the official records. There is no bureaucratic bottleneck. Her paperwork was not lost somewhere in a pile of records or pending registrations. The problem for La Reina is that she does not formally exist. In a sense, both her real estate and business are "unreal." She is forced to operate in a marketplace of informality where citizens – whether consumers, sellers or investors – are

excluded from the formal institutional structures and organizations that presumably exist for their benefit.

Under different circumstances, perhaps in another market or in a different country, La Reina could walk into a bank, meet with a loan officer and secure a line of credit to expand her business. A loan, with her business or home pledged as collateral, could fund a new warehouse that would allow her to break into other markets she has yet to conquer. But she does not have that option because she operates in an environment of informality that is not structurally friendly to markets and growth. Nor is her case unique. Her small business is typical of most that form the backbone of the Peruvian economy: run by individuals or families in their homes or shops on a volatile, short-term cash basis. Her predicament demonstrates the immense obstacles to even simple business development in Peru and elsewhere, and has implications for the country's ability to expand its middle class and secure a stable economic and political future.

Transforming the "Unreal" to Real

People in the developed and developing world face problems similar to those of La Reina. The confusion between institutions and organizations, and the ambiguity or absence of formal property rights are universal. This book tells the story of how a series of institutional changes in Peru successfully transformed "unreal estate" into real estate. The transformation began with a full understanding of how and why institutions had evolved, and then succeeded by overcoming the limitations of traditional corrective approaches that had been used to establish a market based on property. While Peru has its own idiosyncrasies, the story could have unfolded anywhere.

Two elements – institutions and organizations – are essential to understanding and solving the "unreal estate" problem. Two important concepts must follow. Policymakers must see institutions as they are: rules that define and guide socioeconomic human behavior. And, they must see organizations and agencies as tools to implement those rules, not as ends in themselves.

This book will show that transforming unreal assets to real ones offers opportunities to all parties involved – the state, citizens, and investors – provided they have an appropriate vision and can take a long-term view and position. The coming chapters will identify the necessary elements for a successful transformation from the "unreal" to the real, and present the ingredients and strategy of such action.

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