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## **Below the Radar: Underground Markets for the Poor**

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A peddler of vegetables on a Hanoi sidewalk; a heroin dealer in Paris. What do they have in common? More than you might think. Both are operating underground, meaning that, for one reason or another, they choose not to report their activities to the state. They pay no taxes on their earnings. The government does not regulate the purity of their wares. If they have employees, they are not subject to labor regulations on minimum wages and safety. They lack access to the financial system; if they wanted to expand their business they would be unable to get a bank loan. They lack access to the legal system, so if a customer or supplier cheats them they cannot appeal to the courts.

The similarities between our Parisian heroin seller and our Hanoi vegetable seller aside, there is a big, obvious difference. One is supplying a socially harmful commodity. The other is supplying a necessity.

Markets for illicit goods and services—trafficking in drugs or in nuclear weapons or in human beings—necessarily work in secret. But destructive transactions like those make up only a fraction of the underground economy worldwide. Far more vital for most of the world's people is the beneficent form of underground market: entities outside the official economy producing and selling ordinary goods and services like food, cookware, haircuts, clothing, machinery repair, house building—almost everything people use in their everyday lives. The activities in this kind of underground market are illicit, but unlike the market for heroin they are illicit merely on a technicality.

You participate in the underground economy if, as a homeowner, you pay cash to a contractor to avoid taxes, or if you buy a fake Rolex on a city street. (Less than one-tenth of the sidewalk vendors in New York City, for example, hold a license.) In the United States and Western Europe, such activities add up to perhaps ten percent of national income. In poor countries, underground markets are far more prevalent.

Nigeria, Egypt, and Thailand have the world's largest underground economies, estimated (by Friedrich Schneider and Dominik Enste in the *Journal of Economic Literature*, March 2000) to be more than two-thirds the size of official GDP. In Peru, the Philippines, Mexico, and Russia, the underground economy is about a half the size of the official economy. In Tanzania, Chile, and South Korea, it is about a third.

A billion people around the world live on less than a dollar a day, and a further two billion live on one to two dollars a day. Many of those living in unimaginable poverty are dependent on the underground economy, earning their livelihood in it and purchasing their food, clothing, and shelter in it. Devising ways to make underground markets work better, and ultimately to shift transactions currently underground into the formal sector, offers the world's poorest people hope of escaping their grinding poverty.

Why is so much market activity in developing countries underground? Does it matter that firms are outside the official economy; does the underground economy generate inefficiencies? What policies should be implemented in countries with a bloated underground sector?

### ***Government Failure***

In poor countries, the underground economy results from the inadequacy of the state. Entrepreneurs work outside the formal economy because the government is not doing its job. It is doing things it should not do and neglecting to do things it should do. The state is simultaneously too big and too small.

A firm may be underground either by not being officially registered or by being registered but hiding some of its activities from the state. In a survey of small-scale manufacturing firms in Russia and Ukraine that Simon Johnson, Christopher Woodruff, and I ran in the late 1990s, for example, the managers reported that, though registered, they underreported their sales, on average, by about a third.

Government policies may drive firms underground. Entrepreneurs sometimes decide not to register their firms to evade punitive taxation. Or they may decide that the fees to acquire a business license are exorbitant. To register a firm involves a number of steps: entrepreneurs must apply for a business license, establishing that the company's name is unique and usually having to provide proof of startup capital; then they must file

with the tax and labor authorities. Adhering to the rules can be astonishingly time consuming and expensive. In Peru in the 1980s, Hernando de Soto found that setting up a small factory required eleven permits, which took nearly a year to get. A recent World Bank survey found that it is still very costly in many countries. In Mexico, setting up a new business takes an entrepreneur four months and costs about US\$2,500 in official fees. In Bolivia, the cost of working through the licensing procedures adds up to more than twice the level of per capita income. In Tanzania, a business license costs more than three times per-capita income; in the Dominican Republic, it is more than four times. (That such procedures are unnecessarily cumbersome is illustrated by Canada, where to get a business license takes just two days and costs US\$260.) The size of the underground economy reflects the costs of entering the formal economy.

The government's inability or unwillingness to prevent illegal activities is another factor. Rapacious bureaucrats often demand bribes in exchange for granting a business license. Where the police have failed to control crime, firms often stay underground to escape the attention of the mafia, who demand "protection" money. In the sample of entrepreneurs in Russia and Ukraine, about 90 percent reported that it was normal to pay bribes to government officials to acquire a business license or a permit to expand, and a similar percentage said it was normal for firms to pay off the mafia.

Government failure consists not only of the costs entrepreneurs face to join the formal economy, but also of a lack of positive incentives to do so. In principle, a firm that is licensed receives support from the state. In most of the world's poorest countries, however, the government is not supplying the requisite market-supporting institutions.

In many developing countries, firms stay small, even if they are well managed and have a good product, because they are unable to access the external finance they would need in order to grow. Where laws governing collateral are inadequate or unenforced, banks are reluctant to lend to small firms because it would be hard to get their money back if things turn bad. Where financial-market regulation is lacking, new firms cannot get equity finance, because potential investors have no assurance that the firm will not misuse any money they invest in it. Where laws of contract are ineffectual, one of the incentives for entrepreneurs to register their firms—the added reliability of contracting—is absent.

Creating the conditions for effective contracting, viable property rights, and functioning financial markets asks much of the government. Laws must be written, but that is the easy part. Building the machinery of adjudication and enforcement, with courts skilled in judging complex commercial disputes, might take a generation or more. And the courts cannot do the job by themselves. Well-functioning markets need, in addition, proactive regulation.

The Czech Republic in the 1990s followed the laissez-faire prescription, leaving the resolution of financial disputes to the courts. Poland, by contrast, set up a regulatory agency to supplement the courts by enforcing rules to protect investors like mandatory disclosure of information by firms. In Poland, there were relatively few cases of investor abuse; in the Czech Republic, expropriation was rife (as documented by Edward Glaeser, Simon Johnson, and Andrei Shleifer in the *Quarterly Journal of Economics*, 2001). The Czech Republic's hands-off approach resulted in a moribund stock market, with few new share offerings. Poland's active regulator fostered a viable financial market, giving firms the opportunity to grow and attain economies of scale by acquiring outside investors.

A survey of entrepreneurs in Vietnam that Woodruff and I ran in the late 1990s asked whether they had access to the banks; only 10 percent had a bank loan at start-up and 22 percent currently had one. Asked whether they could appeal to the courts to enforce contracts with trading partners, almost all said they could not. India has a logjam in the courts; reportedly 25 million contract-dispute cases are pending, and the cases take ten years or more to reach a decision. In many developing countries, the inadequacy of market-supporting institutions means firms have little to gain from becoming registered.

### ***Contracting without Law***

Millions upon millions of transactions occur every day around the world in underground markets. The dynamism of the underground sector illustrates the potency of market forces. Transactions can be successfully concluded under complete laissez-faire: without laws of contract, without assured property rights, without regulatory oversight. The underground economy shows that spontaneous order can develop so as to allow markets to flourish—but only up to a point. Spontaneous order works only when transactions are straightforward. Beyond that, the absence of government results in

markets being dysfunctional. It is possible to take nonintervention too far. Every economy works better with some management.

Underground markets are not typical of markets in general in that they are relatively uncomplicated. Most of the dealings are pure exchange: food and clothing being sold; immediate services being provided for cash. The goods and services that can be produced and traded underground are inherently limited in nature: they must be simple enough that buyers can easily verify their quality, so there is little scope for a seller to cheat a buyer and little need for a buyer to be wary of being cheated. Underground manufacturing is mostly on a small scale, so economies of scale are lost. Transaction costs in the underground economy are high.

The long-term policy prescription to improve the functioning of underground markets is clear-cut: build the range of market-supporting institutions that underpin the successful economies of Western Europe and North America—the legal and regulatory mechanisms that underpin property rights and contracting; the machinery to ensure deals are carried out as promised, even many years into the future; the rules that assure information disclosure, so that consumers know what they are buying and investors know what is being done with their money.

The harder question is how to get there from here. Building the full set of market-supporting institutions is a project of decades. What can be done to improve the underground economy immediately?

The common-sense prescription is to build on what already works. Entrepreneurs survive in the underground economy by ingeniously creating substitutes for the missing market institutions.

Unable to rely on laws of contract to support their deal-making, entrepreneurs learn how to use ongoing relationships. They deal with people they know. If a trading partner cheats them, they cease dealing with him, so the sanction against dealing in bad faith is a loss of future business. This sanction is strengthened if the loss of business is still wider: if word about the cheating spreads to other trading partners. Gossip is crucial to the functioning of the underground economy. People in the same line of business meet each other every day in tea houses and coffee shops to exchange information on who is

reliable, who is not. Ongoing relationships, underpinned by gossip, substitute for the missing laws of contract.

Unable to get finance from banks or outside investors, underground firms get their finance in the form of trade credit. Sellers offer credit to buyers with whom they have established a relationship, without which the cash-strapped buyer would be unable to do business. The trade credit substitutes for the inaccessible financial markets.

Making the underground economy work more efficiently, in the short run, entails improving the mechanisms on which it already runs. The reliance on ongoing relationships means that, of necessity, deals are done only within a relatively small circle. This circle can be widened by formalizing the gossip mechanism. Trade associations often maintain records of their members' transactions. In Mexico, for example, the shoe manufacturers' association logs its members' dealings with retailers. If a retailer fails to pay for shoes delivered, the manufacturer reports the renegeing to the association. Any other manufacturer, before selling goods, can look up a retailer's record. Retailers, knowing the records exist, have an incentive to pay their bills. Credit bureaus work similarly; by keeping track of those who do business dishonestly, they make doing business easier for the honest people. Trade associations and credit bureaus essentially act as information repositories, making deal-making more reliable.

Trade associations are limited in scope to single industries, however, and credit bureaus focus on financial transactions. During the transition to a full-blown legal system, governments or nongovernmental organizations in countries with inadequate market-supporting institutions might consider setting up broader-based information repositories. Such bodies would not have enforcement powers but would create transparency in contracting. A buyer or seller initiating a transaction with someone never dealt with before could go to the information repository to check whether the potential trading partner's record is clean. Within any current transaction, the prospect that malfeasance has future consequences could be enough of an incentive to live up to the terms of the contract. Information repositories could be a low-cost and quickly implementable mechanism for supporting arms-length transactions in poor countries, offering a way of improving underground transacting.

### ***Who Benefits?***

Why is the underground sector in the world's poorest countries so large? The answer given above is (a) it is costly for firms to register themselves and (b) the benefits from becoming registered are small. But this merely pushes the question back. Why are the costs of joining the formal sector so large? Why are the benefits so small?

There is no mystery in why the benefits are small. The required set of market-supporting institutions is complex. In the United States and Western Europe, building these institutions was a project of a century or more. In today's developing countries, it could take decades, and perhaps it presupposes having a democratic government.

More of a mystery is why the costs of becoming registered are so large. Why do governments deliberately set rules that force an entrepreneur to wait months and pay a multiple of per-capita GDP just to get a permit to run a fledgling firm?

The entry barriers might be a remnant of socialist ideology. Lenin wrote that "small production *engenders* capitalism and the bourgeoisie continuously, daily, hourly, spontaneously, and on a mass scale," so some believed the state should discourage entrepreneurship. Ideology might explain the origins of the entry barriers, but there is still the question of why they persist.

Part of the answer is corruption. Onerous licensing requirements create opportunities for low-level bureaucrats to enrich themselves. By paying a bribe, the entrepreneur can short-cut the licensing procedures and get on with doing business. The higher the official fees and the longer the wait, the bigger is the bribe. Bureaucrats will therefore resist any attempt to ease entry rules.

However, to explain the existence of staggeringly high entry barriers by the petty bureaucrats' desire for bribe opportunities seems a stretch. Where do the clerks who hand out business licenses get the power to determine government policy? Could they be that influential? Some of the bribes they take, to be sure, filter up to their superiors, and perhaps this is enough to explain the size of the entry barriers. But there is another likely set of culprits, people who benefit richly from the rules hindering new firms: the crony capitalists.

In the typical developing country, business is dominated by a few large firms, closely held and politically well connected. In Indonesia, the Philippines, and Thailand,

for example, about ten rich families control about a half of the corporate assets. New firms run by hungry entrepreneurs threaten to chip away at the existing firms' privileges. The last thing the incumbents want to see is the emergence of a home-grown Bill Gates or Mary Kay Ash or Mrs. Fields. They might be using their political strength to induce the government to maintain the legal barriers to entry in order to protect themselves from any incipient competition. If so, shifting activity from the underground sector to the formal sector would mean tackling the incumbent large businesses.

The underground economy is a symptom of the failure of government. We must be precise, though, about the nature of the failure. In the libertarian view, oppressive government regulations bear the full blame. This is simplistic. Oppressive regulations are a part of the story, but only a part. Equally significant is the fact that government is not doing enough, in failing to provide the contractual mechanisms and the financial-market regulation that small firms need to prosper and grow. Moreover, in enacting the oppressive entry regulations, the government may be a tool of big business.

The underground economy brings good news and bad news. Underground markets allow billions of the world's poorest people to get by. But the lack of supporting institutions means that underground markets are handicapped. Enabling growth out of poverty entails shifting these markets above ground, which means changing the rules of the game. Given the powerful interests involved, that will not be easy to do.