

**Fire in the Firehouse?****Preference Falsification and Informal Economic Activity in Peru**

Enrico A. Marcelli

Zagros Madjd-Sadjadi

*San Diego State University**Winston-Salem State University***ABSTRACT:**

*Since Peru's independence from Spain in 1821, and more recently, beginning with the revolutionary doctrine of APRA's founder, Haya de la Torre in 1920, there have been multiple attempts to transform socio-political institutions opposed to mass inclusion of persons working within the 'informal sector'. Paradoxically, Peru has had a history of extremely poor social reform despite the long-term presence of considerable reformist sentiment. In fact, not until the Velasco-led military coup of 1968 did the country become ripe for authentic institutional change. This paper develops a method of studying institutional continuity and change based upon the existence of preference falsification, which until now has been used almost exclusively to model mass revolutionary efforts of a violent nature. The argument is made that to gain a better understanding of why there has never been a mass revolutionary effort in Peru, at least as it is commonly defined, it is necessary to investigate how individual private and public preferences are influenced by the share of society expected to participate.*

**JEL CLASSIFICATION CODES: E26, O17, P48, Z13****KEY WORDS: Public preferences; institutional continuity; informalization**

---

**1. INTRODUCTION**

A former elected official of Peru's American Popular Revolutionary Alliance (APRA) party once wrote, "Una sociedad revolucionaria es una sociedad que reclama rápidos y radicales cambios en sus estructuras económicas, políticas, sociales, administrativas y jurídicas, con la finalidad de obtener un orden mas justo" [Quiroz 1986, 85]. Translated into English, this says, "A revolutionary society is a society that demands rapid and radical changes in its economic, political, social, administrative, and juridical structures, for the purpose of reaching a just order."

This best captures what has been demanded and obtained by those known as 'informals' over the past two decades. In every important socio-institutional domain, creatively and persistently, these entrepreneurs and workers of popular origin have altered the rules of economic and political life in Peru. Thus, even though violent mass revolution, the traditional way that people think of revolutionary societies, has not been successful in Peru since the Revolution of 1895, we can think of Peru as a revolutionary society. Using the word *revolution* to describe changes occurring during this time may seem inappropriate and rather ambiguous, since no single anti-regime movement was attempted by the mass of Peruvian citizens. Its use is surprising, moreover, if we agree revolutions are typically characterized by relatively short and violent conflict between a state and its governed, who oppose it. However, the term "revolution" has a secondary meaning that typifies a radical change in the institutional environment. Thus Mike Harris' government in

Ontario instituted a “common sense revolution”, Chairman Mao in China had the “Cultural Revolution,” the environmental movement in the US instituted a “green revolution.” Yet none of these really convey the concept of revolution from the disenfranchised.

On the other hand, although gradual and admittedly different from other Latin American revolutionary movements (Bolivia, Cuba, Guatemala and Mexico may come to mind), Peru's 'Otro Sendero' has been no less revolutionary, albeit unique in its evolution and more bureaucratic in nature. Although nominally instituted by the government, the changes were often demanded by the populace writ large. Revolutionary movements seeking to change the status quo through violence have existed in Peru and governments have been toppled by *coup d'état*, but no such movement in the 20<sup>th</sup> or 21<sup>st</sup> centuries has resulted in mass revolution, such as has been seen during this time in countries like Iran, Nicaragua, Haiti, and Paraguay. Indeed, the fact such movements (such as Shining Path) have existed but yet been so unsuccessful in generating popular support for their causes is a major paradox to be explained and our answer is the system has generated a method by which revolutionary change can occur without violent revolution. The concept of revolution we employ in this paper is institutional change arising from the bottom, rather than the top, regardless of whether that change is violent or peaceful in nature.

What has distinguished institutional flux and rigidity in Peru from other Latin American countries is the role played by the informal sector. Unlike in most cases, where direct and spontaneous mass revolutionary intervention has been required to bring anachronistic traditional systems of power to their proverbial knees, in Peru these changes are a continuation of struggles begun centuries ago, when mercantilist or oligarchic powers began to yield to more informal or popular interests [Julio Cotler in Lowenthal, 1975, 44-78]. That presented in 'El Otro Sendero', de Soto's [1989] term for Peru's 'invisible revolution' or 'other path', comes to mind. Regardless of what one wishes to label them, there have been countless conflicts between 'peddlers', 'stallholders', 'vendors', or 'informals' and all Peruvian regimes since the end of the 16th century. It was not until the 1980s, however, after the replacement of the Revolutionary Government of the Armed Forces (RGAF, 1975-1980), that informals won for themselves formal institutional respect.

What changed in Peru that permitted political and economic inclusion of those ostracized from the formal politico-economic system for almost 400 years? This paper seeks to explain, using the model of collective choice presented by Kuran [1987], the paradox of why Peru has had a history of extremely slow and poor social reform, despite the long term presence of considerable reformist and revolutionary sentiment. The paradox remains intractable by the Olsonian argument [Olson 1982], which focuses on a lack of organization on the part of the dissatisfied, or by Hirschman's options of exit or voice [Hirschman 1970]. The former cannot explain how groups or even parties such as Sendero and the MRTA or APRA and AP (Accion popular), which have been extremely well organized at times, have failed to alter Peru's institutions in a way that fosters mass participation. The latter theory fails to account for those who oppose the system yet remain with voices muted. The method applied in this paper is complementary to, albeit less complex than, either of these explanations and has the advantage of making sense of Peru's 'ambiguous revolution' [Lowenthal, 3-43]. It can be best understood if we assume supporters of the 1968 Velasco coup, and those involved in informality, falsified their preferences. What changed were circumstances encouraging individuals to misrepresent their private preferences, and perhaps their underlying beliefs.

The structure of this paper is straightforward. The first section provides a brief history of the relations between the Peruvian state and those participating in informality. We argue a crucial

turning point was the 1968 military coup, which attempted to ameliorate tensions extant between poor migrants and persons connected to the dominant oligarchic system. One of the ironies and seeming paradoxes is democratic institutions in Peru have traditionally not served the masses and it is traditionally only when the military has taken power that Peru's great unwashed are given proper consideration, such as during the rules of General Odría from 1948 to 1956 and General Velasco from 1968 to 1975 (Levitsky 1999, 81). Section two presents the logic of preference falsification (PF). The third section explores the institutional changes occurring from the 1968 Velasco coup to 1980 (after which democratic elections were restored). It reveals how rejection of PF by military personnel was indispensable to the success of that coup, and was a springboard motivating informals to oppose the state. The fourth section exposes the role informal PF played throughout the Republic's history. Although threatening sectoral differences were seemingly nonexistent before the coup, these quickly became what promulgated increased conflict in Lima. For various reasons it is argued the coup drove deeply the social wedge which informals had been pounding for at least four decades. History, theory, and household survey data are drawn together in a way that brings new light to the rise of *informalidad* and the weakening of oligarchic institutional structures.

## **2. INFORMAL ECONOMIC ACTIVITY AND THE STATE: A BRIEF HISTORY**

The informal sector is the engine of Peruvian growth. Up to 80% of all women in Lima participate in the informal sector [Lim 1996] and at least 25% of all Peruvian urban households run microenterprises out of their own homes [Field 2005]. There has been a continual rise in the sector's relative share of employment with a plurality of individuals who were employed working in the informal sector by 1991 and only 47.4% in the formal sector [Roberts 1998, 240].

Conflict between the state and those working informally began well before Peru's independence from Spain in 1821. In 1557, the government first instituted action against street vending, a policy repeated at least 20 different times prior to the revolution in 1821 [de Soto 1989, 76]. Yet, by and large, the first 100 years of the Republic saw state tolerance of urban area informality: "Formal society regarded informal trade as part of the city's more and cultural identity and did not feel that such trade might pose a threat to formal trade and transform the face of the city for at the time the number of street vendors was very small." [de Soto 1989, 76]

Different types of regulation began to be imposed by the beginning of the 20<sup>th</sup> century. This coincided with a general trend in many societies to regulate street vending through a policy of accommodation and formalization instead of outright banning. McGee [1973] discusses how states attempted to regulate the inform sector through licensing, education, or relocation to designated spaces as a means to try to formalize the informal. With the informal sector making up over half of many third world economies, modern states desire to tap this vast resource for economic gain.

Yet tolerance likely encouraged migration and increased informality. To this end, in 1915 street vending regulations were first promulgated and required those wish to hawk their wares in the streets of Lima to obtain a permit and abide by certain guidelines, such as not selling food and following health standards. One key provision was the requirement that vendors roam the streets instead of maintaining a stationary position. It was this latter provision that was widely violated due partly to the lack of fiscal penalties, which was rectified the following year [de Soto 1989, 77]

As the informal sector was seen as a source of tax revenue, the power of the informals grew. An excise tax imposed to limit informal activity and collect much needed revenue placed the

government in the precarious position of needing the informal sector more than the informal sector needed the government and increased the informals political power, granting them access to the coveted public spaces and gutting the roaming requirement entirely by 1959 [de Soto 1989, 78]

The informal sector succeeded because vendors linked their activity to not only other informal but also formal businesses. While nominally regulations existed that limited the value of goods and capital in the informal sector and allowed the formal sector to engage in direct competition, the formal sector was hampered by excessive regulation and the fleetness of the informal sector to such an extent that the government tried to organize street vendors into specified areas. The results backfired and vendors organized the Union of Small Traders and Street Vendors and defended themselves against the power of the state either through violence or by moving to parking lots and paying the private owners for the use of their space. The new union and its sister organization, FEVACEL (the Federation of Street Vendors in the Central Market and Adjacent Streets), with which it later joined forces, were the political expression of a group that no longer could be perceived as marginalized or strictly informal and the government began to take them more seriously and grant them established property rights [de Soto 1989, 80-82]

These politico-economic inclusionary processes were paralleled by demographic and military changes and perturbations. In terms of the former, the Peruvian population grew by almost ten-fold from about 650,000 in 1950 to nearly 6.5 million in 1990 [Villa and Rodriguez 1996]. With respect to the latter, by the early 1960s military officials and new recruits alike were questioning the system which had sporadically, yet incessantly, fought to 'keep at arms length' persons migrating from many of the same villages some of them had come.

The informal sector has continued to rise not only in Peru but all of Latin America owing to increased regulatory issues and rising taxes. As the formal sector is squeezed for more revenue, people turn to the informal sector for their sustenance and even formal enterprises often make use of informal ones in order to gain a competitive advantage on costs. Since 1968, when relations were first liberalized, the Peruvian government has alternated between assisting and cracking down on this sector but the ability to formalize the informal continues to evade it. Before turning to the Velasco military coup of October 3, 1968, where we will explore a pivotal moment in the history of Peruvian informal-state relations, the theory of *preference falsification* needs to be explicated.

### 3. A MODEL OF REVOLUTIONARY BENEFIT AND PARTICIPATION

Our approach uses the revolutionary participant's expected direct net benefit function,  $B_i$ , the formation of which owes much to the model of preference falsification given by Kuran [1987], who developed it in the context of violent revolution.

#### *Overview*

Picture a society or a segment thereof considering whether or not to commence an uncertain revolutionary process. For example, let's focus on those working in the 'informal sector', and assume there is consensus among participants regarding the unidimensional nature of the decision at hand. Each individual  $i$  will decide to support the status quo or to help in the effort to alter social institutions, although none is committed a priori to either position. In other words, regardless of what any individual informal privately prefers, he or she can be pressured into either supporting or

opposing the established institutional order and its regime. The share of society expected to oppose publicly the current institutional arrangement,  $s$ , directly influences the perception of the likelihood of revolutionary success,  $P(s)$ , or failure,  $1 - P(s)$ .

Of course, there are many other factors that will contribute to the outcome of any revolutionary effort. Military might and the level of revolutionary organization are two, which are obvious. This does not invalidate, however, the assumption that the number of persons publicly opposing an existing regime is extremely significant with respect to influencing an individual's decision to participate and to the outcome of the collective effort and *ceteris paribus*, directly impact the likelihood of success. Many of these things are, however, directly linked to the level of public support. If they contribute to the likelihood of success, they are linked through the model. If they are exogenously determined from our model, this can be thought of as impacting the level of probability of success through external factors. A more complete model could take these issues into account but the fact the level of popular support also likely influences them, making the separation of such influences rather problematic. Since this is predominantly a theoretical paper concerned with a single empirical case and a single important variable, we are choosing to concentrate only on this one important variable in describing this issue for Peru and are assuming that the decision to participate in the revolution is being undertaken by rational actors who have already determined the likelihood of success given these other factors. Since individual citizens have little or no means of influencing the success or failure of the revolution except by the decision to participate and since we are concentrating our analysis at the individual level, this is a perfectly innocuous assumption in the context of this model of human behavior.

The perceived probability of successful revolution as well as the perceived likelihood others will participate will be higher, the more amenable a country is to change. Democratic societies tend to evolve democratically precisely because they allow change from within. Vocal minorities can often alter a society, especially in areas that are of little concern to the mass populace. The fact informals identified neither with working interests nor business interests due to the dualistic nature of the sector, meant neither faction was likely to pay much attention to them and this can be a good thing because it also meant there was little to gain by opposing their desires: “[I]ssues of employment security, wage indexation, and public benefits that galvanize unions in the formal sector may have little salience to temporary or informal workers who do not receive legal protections or entitlements” [Roberts 1999, 66].

Totalitarian societies hold on much longer to the status quo because the probability of successful action is low unless a large segment of the population opposes the government. Similarly, if a country's government has a dispensation against the change, the probability of success will be lower than it if it is neutral or in favor of the change. Indeed, it is precisely because of sympathy within the military for the informals following the 1968 coup that allowed the informals to lobby in favor of reform. On the other hand, communist movements, such as the Shining Path, by their very nature, lend themselves more to violent revolution because the societies in which they operate tend to have governments that are philosophically opposed to communism and are likely to encounter more stiff opposition and support of the status quo among private sector participants.

Important for our purposes are the expectations of someone in the informal sector concerning decisions of others to participate in the revolution. These will influence an individual's decision whether to oppose the institutional regime publicly and his or her expected net gain.  $B^i$  will be a

function of that individual's expectation of others revolting, or the perceived probability of successful revolution, the net difference between operating informally and formally,  $\mathbf{N}$ , and the cost of joining a revolution,  $\mathbf{C}$ . The last factor is lost whether or not the revolution succeeds.

$$\mathbf{B}^i = \mathbf{P}(s)(\mathbf{N} - \mathbf{C}) + (1 - \mathbf{P}(s))(-\mathbf{C}) \quad [1]$$

$\mathbf{B}^i$  rises with  $\mathbf{P}(s)$  at an increasing rate (where  $d\mathbf{B}/d\mathbf{P} > \mathbf{0}$  and  $d^2\mathbf{B}/d\mathbf{P} > \mathbf{0}$ ) and the probability of gaining the difference of what is typically only attainable for those working within the formal sector,  $\mathbf{P}(s)\mathbf{N}$ , less the costs of revolution, must be equal to or exceed zero, as in equation [2], if an informal worker is going to consider revolution worthwhile.

$$\mathbf{P}(s)\mathbf{N} - \mathbf{C} \geq 0; \quad [2]$$

In other words, there will exist some level of revolutionary participation,  $s^*$ , which will satisfy [2], constrained by the net revenue disparity and the cost of the revolution. The movement appears beneficial, obviously, when  $\mathbf{B}^i \geq \mathbf{0}$  or once the probability of successful revolution times the net revenue differential equals or exceeds the cost of revolting as in [3].

$$\mathbf{P}(s^*)\mathbf{N} \geq \mathbf{C}; \quad [3]$$

Dividing through by the differential we obtain [4], which reveals the probability threshold beyond which one will expect the revolution to succeed and to receive a positive net benefit.

$$\mathbf{P}(s^*) \geq \mathbf{C}/\mathbf{N}; \quad [4]$$

As we shall see momentarily, the latter expectation for those who do not join the revolution, as well as the decision itself, will be a function of the likelihood of being detected during or after the revolution and its adverse retribitional consequences.

Assuming an S-shaped relationship between the expected probability of successful revolution and the share of societal revolutionary participation,

$$s^* \geq \mathbf{P}^{-1}(\mathbf{C}/\mathbf{N}). \quad [5]$$

The justification for the functional form,  $\mathbf{P}^{-1}$ , is that as the number of persons joining the revolutionary effort increases, the probability of success does also, thereby augmenting an individual's expectation of receiving a positive  $\mathbf{B}^i$  as revolutionary forces mount. At first, as few participants will not be sufficient to generate a required level of collective action, the probability of success rises relatively slowly. Eventually, if enough people publicly support the revolution,  $\pi$  begins to rise quite rapidly. Soon thereafter a point is reached beyond which additional revolutionaries will contribute little to the probability of success. That given in [5] thus becomes

$$s^* \geq \left[\left(\frac{1}{\pi}\right)SIN^{-1}(2\mathbf{C}/\mathbf{N} - 1) + 1/2\right] \quad [6]$$

$$P(s) \geq \left[ \left( \frac{1}{2} \right) \text{SIN} \left( s^2 \pi - \frac{1}{2\pi} \right) + 1/2 \right] \quad [6a]$$

Equation [6a] is graphed below in Figure 1.

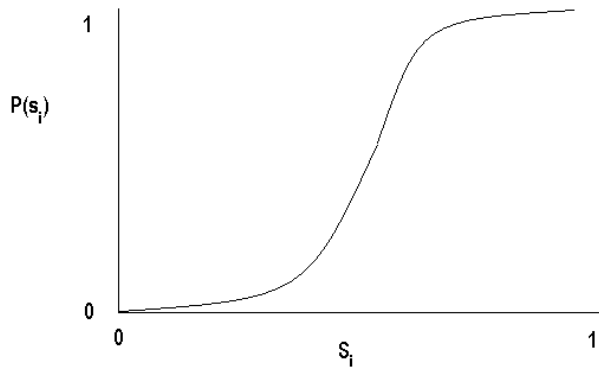


FIGURE 1: Probability of Successful Revolution

To solve this equation for the society share,  $s^*$ , needed to make [6a] true, and obtain [6] above, we must determine values for  $N$  and  $C$ .  $N$  is herein defined as the difference in expected pay between the formal and informal sectors, although there may also be psychological aspects that are not quantifiable.

The cost of revolting is,  $C$ , among other things, a function of expected future earnings,  $E$ , currently owned inventories,  $I$ , and capital,  $K$ . Hence, and  $dC/dE > 0$ ,  $dC/dI > 0$  and  $dC/dK > 0$ .

$$C = C(E,I,K); \quad [7]$$

The cost of a revolution is composed of other factors as well. Regardless of the outcome, one may lose a family member, friend, or co-worker in addition to his or her informal business investments. While some of these are economic and thus can be calculated, such as one's level of old-age security [Nugent 1985], others are psychological in nature and are not quantifiable.

***The Choice of Individual Public Proclamation***

We have seen how each individual member of the informal economy takes into account how many other people he expects to join the revolution or their anti-establishment publicized preferences, the net revenue differential between formal and informal sectors, and the estimated cost of revolution. However, we have only hinted at how an individual decides to participate in the revolution or not.  $B^i$  does not necessarily determine a particular individual's decision.

Obviously the smaller the group the less this holds true. In the present case, however, the legalization of informal economic activity  $a$ , resulting from struggle  $b$  and resulting in aggregate

benefit  $c$ , does not necessarily impede nonparticipants from feasting on the fruits of the revolutionaries' labor. The argument is made stronger the more difficult nonparticipation is to detect. Assuming the share of society anticipated to revolt is sufficiently high enough that the expectation of successful revolution is great, each informal may realize that his or her contribution is relatively insignificant. In short, at some point  $\mathbf{P}(s)$  may become sufficiently large, encouraging some to free-ride. Not fighting for the cause, then, and not being detected, may combine to provide a considerable incentive for risk aversion during the revolution. Moreover, one does not automatically have to participate in the effort to receive the benefits resulting from a fortuitous outcome. Yet, the very success of the effort may also mean an informal who supported the status quo is left in a precarious position. If caught opposing the effort via passivity toward the state, or worse, anti-revolutionary activity, one risks the possibility of losing all the costs of revolution as presented above and more.

The additional loss can be split into two functions, the first incorporating an individual's reputation and the second, his integrity [Kuran 1987, 644-45]. The decrease in utility resulting from one's cart being confiscated by the authorities during a period of transition, but also be ostracized afterwards for not having aided fellow informal revolutionaries, is an example of the former. The latter is illustrated by the utility lost from one's desire to reveal his or her private preferences, yet falsifying them due to public pressure. For example, an informal may privately detest authorities for having taken a relative's capital, etc., but still not join the revolution for fear of the same happening to him. Similarly, one could decide to join a revolution even though one does not support change because of a fear of retribution after a successful revolution has occurred.

We shall represent what one loses upon being detected during or after a successful revolution by  $V(\mathbf{x}^i, \mathbf{y}^i)$ , which is a function of one's reputation ( $\mathbf{R}(\mathbf{y}^i)$ ), and integrity ( $\mathbf{G}(\mathbf{x}^i, \mathbf{y}^i)$ ).

$$R(\mathbf{y}^i) = \begin{cases} f_0(S_0) & \text{if } \mathbf{y}^i = 0, \\ 0 & \text{if } 0 < \mathbf{y}^i < 1, \\ f_1(S_1) & \text{if } \mathbf{y}^i = 1, \end{cases} \quad [8]$$

where  $\mathbf{S}_0$  and  $\mathbf{S}_1$  represent the share of society representing supporters of, and those opposing, the existing institutional regime, respectively, and  $\mathbf{x}^i$  and  $\mathbf{y}^i$  representing private and public preferences.

$$G(\mathbf{x}^i, \mathbf{y}^i) = G(1 - |\mathbf{x}^i - \mathbf{y}^i|), \quad [9]$$

where  $\mathbf{G}$  is increasing in its argument (which is a measurement of the closeness between an individual's private and public preferences). We now can understand the second and third factors taken into consideration by the potential revolutionary participant. These are combined to give,

$$V(\mathbf{x}^i, \mathbf{y}^i) = T(\mathbf{y}^i) + G(\mathbf{x}^i, \mathbf{y}^i). \quad [10]$$

The absence of  $\mathbf{B}^i$  from the right hand side of [10] does not imply the individual does not place importance on it, rather each individual, seeing himself as a infinitesimally small part of the revolutionary effort, does not believe his contribution will alter the probability of successful revolution, and hence,  $\mathbf{B}^i$ .  $\mathbf{x}^i$  however, is reflected in  $\mathbf{B}^i(s)$ , since the latter is simply the preference ordering of that individual. This is the free-rider effect.



The decision whether or not to participate is shown by [11], where the left hand side is the expected positive net benefit of participating and the right hand side is the expected negative net benefit of having opposed the revolution in some manner and having been detected.

$$P(s)(N - C) \geq P(s)[-V(R(y^i), G(x^i, y^i))] \quad [11]$$

Although each informal is assumed to have the same reputational and integrity functions, their undisclosed private preferences may be different, and consequently, the values of  $x^i$  and  $s$  which make [11] true may be different for each individual.

To clarify the approach being developed, we will assume that no individual will choose a nonoptimal position. This means, as was assumed above, each person will avoid being indecisive publicly and select either to support or to oppose the currently dominating regime. Hence, the case we are interested in is where for all  $i$  ranging from 0 to 1,

$$\max (V_0^i, V_1^i) > V_*^i, \quad [12]$$

and the share supporting and opposing sum to 1. Under these conditions, the utilities gained from either public choice become

$$V_0^i = f_0(1-s_1) + G(1-x^i), \quad [13]$$

and,

$$V_1^i = f_1(s_1) + G(x^i). \quad [14]$$

Given  $f_0$  and  $f_1$ , and by equating [13] and [14], we can solve for each  $s_1$ , the value that  $x^i$  must assume to make an informal indifferent between deciding to revolt or deciding not to revolt. In short, we can find the level of public support beyond which private preferences are inconsequential to the inevitability of revolution, and before which they make all the difference.

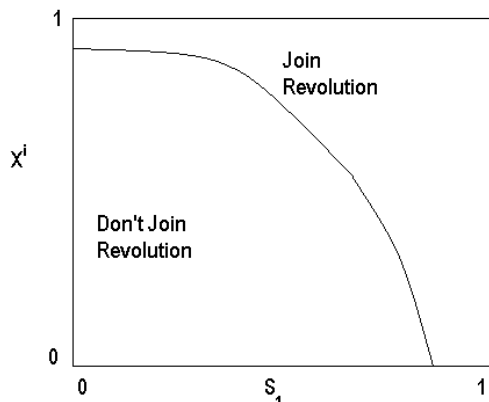


FIGURE 2: Private Preferences and Participatory Share  
See Kuran [1987, 646]

In figure 2, those with a point  $(s_1, x^1)$  lying below the curve will support the status quo, and those with a point lying above it will support the revolutionary effort. Indeed, even though a government may be widely hated behind private closed doors, to the public eye its support is unwavering. This is simply because people are unwilling to oppose such a regime unless others are likewise willing to take up the cause. Yet, at the same time, change may occur rapidly and owing to the smallest and most seemingly insignificant action, as each individual's decision to join a revolutionary movement depends on their perception of whether others are similarly committed. In the case where only a small change in perceived public support for action can cause the mobilization of a large segment of society, the effect can be similar to that of a snowball, gathering momentum as it careens down the mountainside. Each person who joins the cause creates, as through a bandwagon effect, a sea change in public support that builds into a revolution [Kuran 1989, 42]. Indeed, when a revolution is all but certain to succeed, one might as well join the revolution because of the serious repercussions that may befall one if one does not join.

### 3. THE 1968 COUP: PREFERENCE REVELATION AND INSTITUTIONAL TAKEOVER

The coup of RGAF, led by Juan Velasco Alvarado and replacing the Accion Popular government on October 3, 1968, attempted to redress disparities separating Peru's formal elites from her informal poor. That Peruvian military leaders did it, so surprised Fidel Castro that he said it was as if "the fire had started at the firehouse" [Lowenthal, 21]. Yet, during the next twelve years the flames turned to smoke and informal-state relations remained, for all practical purposes, intact. Due to altered circumstances, the gap between society and state broadened, and pressures for institutional change surged. Contrasted with Mexico, where state and informal business has traditionally worked together, Peru's history of conflict resulted in institutional ossification and growing dissatisfaction [Cameron 1992, 209-220]. This led informals to believe they could capture some of the formal sector's rents if a different institutional arrangement existed.

We will explain how the military emerged as mediator between oligarchic and informal interests, and created circumstances conducive to informal preference revelation (PR), where refusing to falsify one's private preferences in public results in preference revelation.

World economic trading patterns that immediately followed World War II resulted in an attack on the traditional oligarchy and on the Peruvian *gamonal* system. Before this time the export oligarchy and semifeudal *haciendas* worked together so the former exported raw materials coming from the latter, and in return, received manufactured capital and luxury goods from abroad. Although these two sectors were deeply interconnected and dependent upon one another, their persistence was remarkable, and "the analyses of Peruvian society carried by Haya de la Torre and Mariátegui in the 1920s continued to pertain in the 1960s" [Cotler in Lowenthal, 1975, 47]. Local capitalists were controlled mainly by US capital, and this made possible the close economic and political relationship. However, this eventually led to modernization pressures that resulted in higher unemployment and placed greater absorption responsibility on the informal sector.

New forms of capital accumulation led to decreased importance of traditional modes of production without eliminating dependent oligarchic institutions. As migration quickened, so did the number of peasant revolts and strikes, alongside increased growth and investment diversification. Political and ideological divisions coincided with economic, and the army and the

church sided with the non-oligarchic interests. Whereas both institutions had always supported the ruling oligarchy, the former feared a rise in revolutionary, the latter in 'anti-Christian,' forces.

Consequently, a great concern for internal security developed and places like CAEM (el Centro de Altos Estudios Militares) began to increase their training of counterinsurgency techniques. Most relevant for our purposes, though, these techniques included the possibility of using reformist measures in place of violent repression. It can be reasonably argued, however, that the crisis between oligarchic and informal sectors during the 1960s, led to changes in military and religious postures toward state institutions, which resulted in the suppression of mass-based movements and an attempt to eliminate traditional institutional arrangements.

Nonetheless, on the eve of the Velasco coup, the military succeeded in toppling AP's control of the state. Unlike other anti-oligarchy movements, however, Peru's was more bureaucratic and excluded the political participation of the masses. This was possible only because of the weakened condition of the traditional or informal sector, and due to the failure of leftist or guerilla groups to seize power. In general, the ironic goal of the new administration (given its historic predisposition of rescuing the oligarchy) was to eradicate class differences by a homogenization of society. It was ironic given its historic predisposition to coming to the rescue of the oligarchy. For the purpose of this paper, the most interesting action taken by the military was to encourage PF by suppressing political disagreement within and outside of military circles.

For example, in addition to attitudes generated at CAEM, Cotler [in Lowenthal, 1975, 58] notes "the institution as a whole... was in charge of carrying out the transformation of the country," but "in 1968, the military 'institution' was, in fact, divided over the October 3 coup." Amazingly, the coup was planned by only eight military officers and it was not until it began that those who were previously content to let the oligarchy continue (having privately rejected its discriminatory nature toward the masses, but having a latent distrust toward the them) 'voiced' their dissatisfaction toward Balaunde's regime. Some of this discontent can be traced back to CAEM and the reformist attitudes transmitted there, but as Lowenthal [1975, 22] argues, not even this "can provide a sufficient explanation for the military's comprehensive reform program."

Whereas neither the organizational theory of Olson, the 'exit, voice, or loyalty' approach of Hirschman, nor simply appealing to the military's training adequately explains either the success of the coup or the reformist policies undertaken; and that individual officers and others in the military privately rejected Peru's institutional structures, only to reveal this when it was perceived safe to do so, lends credence to the role played by PF and its subsequent elimination. If it is to be believed, however, that PR explains the coup's success, then PF must be shown to have been the basis for earlier institutional inertia. This will be shown in the following section.

How did changes during the military's reign affect informality? First, the Velasco regime had three primary objectives - to move against the oligarchic orientations of governments ruling since 1930, to strengthen the state by giving it a more direct role economically, and to limit mass political participation [Lowenthal, 1975, 45]. Generally, these would be achieved by ruling corporatively over oligarchic interests and by depoliticizing the lower and middle classes. Second, although the military's rhetoric was nationalist or anti-sectoralist, it did little to shake the structure of economic relations, one reason why it is improper to call the coup a revolution. Specifically, the new government continued to subsidize the modern sector by encouraging private accumulation, and although fishing, banking and commerce, were nationalized, mining was reorganized, and a new nationalistic foreign policy adopted, only a very limited redistribution occurred. As Richard Webb

shows [1977], only within sectors did any significant redistribution occur and the overall transfer resulting from these policies was insignificant in relation to the national income. The moral of the story is this: reformist rhetoric did not lead to real changes for Peru's most poor.

A look at informality in Lima from 1968 illuminates this well. We previously saw that informals had come to be recognized formally. The impetus for this change lay in the violent conflict following the government's effort to move informal vendors to pre-chosen locations not initially acceptable to vendors. With Velasco's mayoral appointment of Eduardo Dibos Chappuis in 1970, the relocation of informals continued, but this time without using force. Street vending was seen as a long run issue to be combated bureaucratically. Dibos met with vendor organization leaders and in return for a non-taxed right to occupancy, they extended their political support.

By 1976 areas occupied by street vendors came to be called 'free zones' and the second part of the RGAF (1975-1980) witnessed the creation of a multi-sectorial commission, where vendors and municipal authorities alike discussed informal ownership and activity issues. The commission gave informals the security they longed for and responsibility of informality was passed down from executive auspices to municipal authorities [de Soto, 85]. In April of 1978, in response to the large number of informal markets being created, things took a turn for the worse when the municipal authority abandoned its passive approach toward informality, and issued a violent offense against it.

Some believe this was an attempt to move against Marxist-led vendor organizations, which had secured considerable power in the formal governmental structure. Regardless of the reason, under 'Operacion Sombrilla' vendors were kicked out of certain areas they were occupying, and the police attempted to prevent them from returning for many hours. The persistence of the vendors proved too much, for as soon as the police would leave the vendors would take back their pitch spaces. In the end, it was clear vendor evacuation was impractical [de Soto 1989, 86].

It was not long before certain vendor leaders, and politicians sympathetic toward their concerns, gained mass political support and were elected into municipal and federal offices. More than pledging their political support, however, the vendors began to improve the appearances of their pitches under residential pressures and created, with the help of a team of experts, a vending bill which they wanted presented to congress. Three days later, on July 28, 1980, Balaunde was reelected president, thus ending twelve years of military rule.

The new administration, down to the municipal level, entered office with the knowledge of how much ground had been gained by informals, but also had to cope with the interests of the middle class and disdain for what was perceived to be one of the most deplorable social legacies remaining from military rule. In March of 1981 it was announced that street vendors would leave central Lima for good and relocate in places like Polvos Azules. Once again there was violence. For three months there were mass "meetings, marches and protest demonstrations, vehicles were stoned, and Molotov cocktails were thrown" [de Soto 1989, 88]. It seemed as though relations had come full circle, and little had changed. By 1985 all of the regulations existing before 1981 had been reintroduced and additional ones added. In general, vendors were given back their right to sell their wares under certain stipulations. The only difference was now informals had to join a vendors' organization. Circumstances once conducive to preference falsification had changed.

After the 1968 coup, informals won for themselves private ownership, however precarious, and they created markets for their goods when they could. It should be obvious, regardless of the coup's failures, that what occurred in 1968 gave formal and forceful credence to the relevancy of informal institutions and their rules. Whatever argument can be made for the gradualness of the informals'

struggle, it is clear that as a greater share of society came to accept or support informality in Lima, and as pressures against it grew, informal boldness was fortified and the number of those willing to reveal their private preferences swelled. As we shall see momentarily, not only can PF explain why the military coup did not occur until October 3, 1968, but it is also why informals refrained from mass violent action against the state, which incessantly constrained their activities.

#### **4. THE ROLE OF INFORMAL PREFERENCE FALSIFICATION**

Section one along with the previous section renders unacceptable the idea that the Velasco coup and the military's rule significantly altered the structure of informal-state relations. In short, we have seen how hostile feelings toward the state existed before the 1968 coup, and were extant even after the military's rule ended. Circumstances from 1968 to 1980 only served to further legitimate the need for informals to secure property rights and meaningful political participation.

What explains the sudden emergence of informal opposition forces if repression existed before the coup? Clearly, coercive action had been taken against informals by the republic since the start of the 20<sup>th</sup> century. We believe PF was the cause of institutional stability. Repressive forces existing before 1968 justifies this assumption. Moreover, though informals paid the state's unfair excise tax (greater for informals than those in the formal sector), while being uncertain of receiving public space, some must have quietly disapproved, and that PF existed after the coup as well.

As modernization forces gained strength, it became clear revolutionary statements made by the military would not lead to social reform. As Carol Graham [1990, 79] stresses, "reformist tactics can achieve revolutionary objectives if a reassuring atmosphere is provided." No such atmosphere was provided and many rural Peruvians felt compelled to migrate, become informal, and accept very uncertain conditions. It was during that time and continuing through the 1980s (since the Balaunde and Garcia regimes also demonstrated what APRA's Haya de la Torre called a "vieja democracia verbal" [Graham 1990, 76]) that informals were quickly becoming indifferent toward the benefits of PF and the expected rewards of PR.

#### ***Review***

Our analysis began by showing how PF impeded any kind of mass informal revolution during the first century-and-a-half of the republic. We saw that similar repressive forces existed before, during, and after the Velasco coup, but that class differences became more obvious soon after October 3rd, 1968. We saw how eventually informals became convinced of the inadequacy of their PF to justify quiet compliance and political passivity. Moreover, we saw that oppressive forces, which are a motivation for falsifying antiregime preferences, began to wane.

Were public preferences simply internalized by informals before Velasco, and they, along with military personnel, happily decided to submit until then? Our answer is no. The hostility that greeted the migrants generated a rebellious spirit that was demonstrated time and time again. The Velasco regime, although not altering social relations nor economic distributional patterns, did create an environment in which informals could more safely oppose the state. Not only were the informals greater in number, but also many within the military were sympathetic to their cause. This did not mean repression would not ensue, however. It simply meant informals perceived

established institutions as inconsistent and irrelevant to their lives, a factor which led to the collapse of the leftist municipal governments that flourished at first in the 1980s (Schonwalder 2002).

### *Empirical Evidence*

What has been presented is anecdotal or circumstantial, but the analytical methodology is consistent with what transpired between 1968 and 1980. Using the World Bank's 1990 LSMS household survey data, we can also obtain an estimate of an individual informal's  $B^i$ . Recall from section two that  $B^i$  is a function of  $s$ , the expected share of antiregime public preferences. With a sample of 756 individuals located in Lima, the data show that individuals participating in the formal sector had mean net revenue of 16,169,000 intis (or \$323.00) per month, while those in the informal sector had mean net revenue of 9,960 (or \$199.20). The difference between these two points represents  $N$ , the net expected benefit from revolution. The mean revolution costs,  $C$ , were found to be a mere 676,300 intis or \$13.53. Using these figures and the model presented above we find for there to be a positive expected net benefit from successful revolution, approximately 45 percent of the population would have to be seen opposing the status quo in 1990.

Figure 3 shows the expected share of society needed for an individual informal to perceive that there will be a positive direct net benefit of revolution.

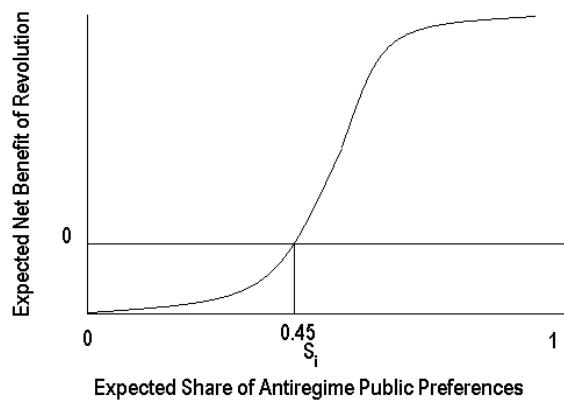


FIGURE 3: Expected Direct Net Benefit and Share of Anti-Regime Preferences

It is probable these results adequately reflect the amount of PF Peru's informals still exhibit. The 1980s, although returning to a more 'democratic' political process, were also characterized by anti-informal policies. By the beginning of this decade, de Soto's hope of a state supportive of informality was still absent. This is not surprising given the relatively high threshold of anti-regime public preferences needed to sway the expectations of informals. Despite increased violence against the state, and Fujimori's closing of the congress in April 1992, Peruvians in Lima, or at least those working informally, did not believe the probability of successful institutional change, via revolution, was very high. Fujimori's *autogolpe* (self-coup) and the resultant rise in unchecked power of the hated SIN, Fujimori's secret police, saw informals trapped between a revolutionary movement that did not espouse the values they held dear (Shining Path) and a democratically elected politician turned dictator (Fujimori). This further complicated the situation.

Not only were values espoused by the Shining Path not always congruous with those of the informals, many rural peasants also saw the revolutionary movement not as savior but enemy (Degregori 1998). Thus, initially, Fujimori's actions were seen in a positive light by the Peruvian people, at least in the public façade with nearly 80% backing the *autogolpe*, presumably because of the worries over hyperinflation, the increased guerilla activity of the rebels, and a perceived crisis of ungovernability (Levetsky 1999, 80). One critical error made by Shining Path, when it attempted to organize in the late 1980s in Lima, was in maintaining its patriarchal structure in light of the enormous impact that women had in the informal economy. By relegating women's roles to organizing neighborhoods instead of ensuring their voice in a functional manner, they denied themselves an opportunity to translate informal resentment into collective action (Cordoro 1998). It is for this reason that informals generally continued to work as they always had, disregarding when they could how the state felt about them, and tried to change institutions administratively instead of violently. As history has shown, however, if pressed too hard, informals will react violently. Ironically, while Fujimori's failure to deal decisively with the terrorist threat posed by Shining Path led precipitously to declines in his popularity as manifested by polls and the resultant MRTA hostage-taking crisis of December 1996 to April 1997 during which time the Japanese ambassador's residence was stormed caused a near doubling of his popularity when it was successfully resolved (Cameron 1998, 127-8), Fujimori's success in dealing with terrorism may have also led to his eventual ouster because the rationale behind his seizing of power would no longer hold once the threat was alleviated. Indeed, when Fujimori abruptly resigned and announced the dissolution of the SIN in September 2000, the National Intelligence Service that was Fujimori's secret police, demonstrators took to the streets as they realized that others would likely join as well.

## 5. CONCLUSION

Under Velasco, pressures against informals falsifying their preferences were augmented. The years immediately preceding Velasco's takeover were characterized by the desire for economic development apart from traditional oligarchic relations, which were dependent upon the *gamonal* system. As migration increased and modernization spread, both the church and the military came to oppose the state. The rejection of Balaunde's government by the Revolutionary Government of the Armed Forces did not strengthen oligarchic control of the nation, but nor did it significantly alter the institutional structure so as to foster greater economic and political participation by informals.

During the military's twelve year reign, the state was, if only rhetorically (or formally), sympathetic to informal concerns. Unfortunately, as regimes returned to violent repression, informal-state conflict became more flagrant. The seeds of increasing informal optimism, however, were sown during the military's rule, and informals in Lima began to see they could successfully deflect government attacks. The result, as we have seen, was not a glorious change in how the state confronted informality, rather a profound transformation in the way informals perceived their chances of changing or avoiding exclusionary institutions. Perhaps it was astonishing a handful of generals who historically sided with the ruling oligarchy planned a 'successful revolution', but the 'victory' would not have come without many military personnel deciding to stop falsifying their private preferences. Moreover, that which took place between informals and the state has become more evident. The impetus for informal PF became less severe as the military became more tolerant of informality, and as legal constraints continued to be irrelevant.

## REFERENCES

- Cameron, Maxwell A., et al. (1992). "Micro and Macro Logics of Political Conflict: The Informal Sector and Institutional Change in Peru and Mexico," *Latin America To The Year 2000*, Praeger, New York, NY.
- Cameron, Maxwell A. (1998). "Self-Coups: Peru, Guatemala, and Russia," *Journal of Democracy* 9(1), 125-139.
- Cordoro, Isabel Coral (1998). "Women in War: Impact and Responses" in Steve J. Stern, ed., *Shining and Other Paths: War and Society in Peru, 1980-1995*, Durham, NC: Duke University Press.
- Cotler, Julio (1975). "The New Mode of Political Domination in Peru." In Abraham Lowenthal, ed. *The Peruvian Experiment: Continuity and Change under Military Rule* Princeton: Princeton University Press
- de Soto, Hernando (1989). *The Other Path*, New York, NY: Harper and Row Publishers.
- Degrigori, Carlos Ivan (1998). "Harvesting Storms: Peasant *Rondas* and the defeat of Sendero Luminoso in Ayacucho" in Steve J. Stern, ed., *Shining and Other Paths: War and Society in Peru, 1980-1995*, Durham, NC: Duke University Press.
- Field, Erica (2005). "Entitled to Work: Informal Enterprise in Urban Peru" Development Outreach, March, <http://www1.worldbank.org/devoutreach/article.asp?id=284>
- Graham, Carol (1990). "Peru's APRA party in Power: Impossible Revolution, Relinquished Reform," *The Journal of InterAmerican Studies and World Affairs*, 32, no. 3, 75-115.
- Hirschman, Albert O. (1970). *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*, Cambridge, MA: Harvard University Press.
- Kuran, Timur (1987). "Preference Falsification, Policy Continuity and Collective Conservatism," *The Economic Journal*, 97, 642-665.
- \_\_\_\_\_ (1989). "Sparks and Prairie Fires: A Theory of Unanticipated Political Revolution," *Public Choice*, 61, 41-74.
- Levitsky, Steven (1999). "Fujimori and Post-Party Politics in Peru," *Journal of Democracy*, 10(3), 78-92.
- Lim, Lin Lean (1996). *More and better jobs for women: An Action Guide*, Geneva: International Labor Organization.
- Lowenthal, Abraham F. (1975). *The Peruvian Experiment: Continuity and Change under Military Rule*, Princeton, New Jersey: Princeton University Press.
- McGee, T.G. (1973). *Hawkers in Hong Kong*. Center for Asian Studies Monographs and Occasional Papers No. 17, Hong Kong: University of Hong Kong.
- Nugent, Jeffrey B. (1985). "The Old-Age Security Motive for Fertility," *Population and Development Review*, 11, no. 1, 75-97.
- Olson, Mancur (1982). *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities*, New Haven, CT: Yale University Press.
- Quiroz, Pedro Arana (1986). *Providencia Y Revolucion*, Grand Rapids, MI: Subcomision Literatura Cristiana.
- Roberts, Kenneth M. (1999). *Deepening Democracy? The Modern Left and Social Movements in Chile and Peru*. Palo Alto, CA: Stanford University Press.



- Schownwalder, Gerd (2002). *Linking Civil Society and the State: Urban Popular Movements, the Left, and Local Government in Peru, 1980-1992*. University Park, PA: Pennsylvania State University Press.
- Villa, Miguel and Jorge Rodríguez (1996). "Demographic trends in Latin America's metropolises, 1950-1990" in Alan Gilbert, ed., *The Mega-City in Latin America*, Tokyo: United Nations University Press, <http://www.unu.edu/unupress/unupbooks/uu23me/uu23me00.htm>.
- Webb, Richard C. (1977). *Government Policy and the Distribution of Income in Peru, 1963–1973*. Cambridge: Harvard University Press.

---

The authors would like to thank Professor Timur Kuran for helpful suggestions during the formative stages of this paper as well as two anonymous referees for the *American Review of Political Economy*. All errors remain the responsibility of the authors.

**CONTACT INFORMATION:**

Enrico A. Marcelli  
Assistant Professor of Sociology  
San Diego State University  
[enrico.marcelli@sdsu.edu](mailto:enrico.marcelli@sdsu.edu)  
&  
Zagros Madjd-Sadjadi  
Associate Professor of Economics  
Winston-Salem State University  
[sadjadizm@wssu.edu](mailto:sadjadizm@wssu.edu)