

TEXAS PAPERS ON LATIN AMERICA

Pre-publication working papers of the
Institute of Latin American Studies
University of Texas at Austin
ISSN 0892-3507

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An Analysis of Third World Urban Housing

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Paper No. 87-07

**RENT SEEKING, RENT AVOIDANCE, AND INFORMALITY:
AN ANALYSIS OF THIRD WORLD URBAN HOUSING**

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Any number of concepts and ideas have been set forth over the past two or three decades to describe and explain the various problems common to urban development in Third World countries. Perhaps foremost among these has been the notion of the urban informal economy, a topic that has generated an enormous literature and that has, despite (or even because of) considerable debate and argument, provided considerable analytic leverage when brought to bear on the topic of Third World urban development and underdevelopment. Yet while this concept has been indeed useful, it may become even more so if linked with two notions from applied economics, namely, the ideas of *rent seeking* (hereinafter sometimes referred to simply as R-S) and *rent avoidance* (R-A).

The terms, which are closely related, do not deal with the usual meaning of the term "rent", especially in the context of landlord-tenant relationships. Rather, rent here refers to "that part of the payment to an owner of resources over and above that which those resources could command in any alternative use" (Buchanan 1980: 3). Or, in other words, rent and rent seeking emerge in a situation when "an individual . . . invests in something that will not actually improve productivity or will actually lower it, but does raise his income because it gives him some special advantage or monopoly power" (Tullock 1980: 17). Examples taken from real life of R-S behavior generally involve payments made by an entrepreneur (or would-be entrepreneur) to a government to obtain the right (in the ideal, exclusive, but not necessarily so) to produce something. An importer may bribe an official or officials in order to be able to import certain goods or equipment that are necessary and valuable to them in a business enterprise. Indeed, such payments may simply be a way of doing business in some cases, where governmental bureaucracies and policies may be otherwise impenetrable or immovable. A rent-seeking economy or society is thus one in which a great many people invest money and other resources in seeking a job (or a privilege), thereby making these resources useless for any other purpose, that is, wasting them (ibid. 1980: 24). A state may also be thought of as rent-seeking if it imposes legal and other restraints, obstacles, burdens, and delays to such an extent that they make it necessary for a large percentage of its population to spend resources in rent-seeking activities or (especially, perhaps, its low-income members) to take steps to avoid such restraints.

While certain entrepreneurs may be willing and indeed anxious to meet such costs if the payoff is sufficiently large, others may attempt to find ways to avoid such costs. R-A behavior involves the expenditure of resources to minimize costs (bribe solicitation, for instance) that can be imposed on any business by the state. Such costs might include paying officials who must be bribed to expedite bureaucratic procedures or legislators who must be compensated for passing or blocking legislation favorable or unfavorable to entrepreneurial activity (Tullock 1980: 31). Rent-seeking activities may be efficient and rational from the standpoint of the individual enterprise or entrepreneur. However,

they may also involve a tremendous waste from the standpoint of the society as a whole. Large resources in terms of human capacity are diverted to the rent-seeking part of the government and the rent-avoidance activity in the private sector. In these rent-seeking societies . . . they are, in a real sense, the major sources of income and wealth. . . . In a way, [it] is a vast negative-sum game. (Ibid. 1980: 31)

A good deal of work on rent seeking has been done in the context of the Third World. The intent here is to use it as a partial explanation for the emergence of the so-called informal economy in Third World urban settings and for generating and addressing specific questions concerning land use and land speculation, urban reform policies, and the emergence of autonomous settlements as a rent-avoidance activity in response to rent seeking by the state. I shall employ Peru and its capital of Lima as an empirical case for examination and reference.

A RENT-AVOIDANCE MODEL AND THE INFORMAL URBAN SECTOR

Let us posit the existence of a nation that is itself poor, that contains large numbers of poor people, and the state apparatus of which attempts to control an urban economy that has the following characteristics: (1) the urban setting in general has a large labor surplus and therefore a wage scale that provides minimal benefits to the average laborer, both in terms of remuneration and of state-sponsored benefits (for example, enforcement of minimum wages, social security benefits); (2) the state's bureaucratic apparatus places numerous obstacles in the path of any entrepreneur, large or small, for virtually all manufacturing, commercial, service, or construction-related activity. The state, therefore, can be characterized as being, at least in substantial part, a rent-seeking state, both on the level of the state apparatus and on the individual level of its officials in charge of implementing its policies, formal (for example, seeing that all bureaucratic steps are taken when opening or maintaining a business) as well as informal (for example, making bribery a way of not only expediting but of simply doing business).

Within such a state and nation, we can hypothesize that, if its citizens act rationally, certain results will follow. In the broadest terms, an informal urban economy, which is generally characterized as having ease of entry, reliance on indigenous resources, family ownership of enterprises, small scale of operation,

labor-intensive and adapted technology, and unregulated and competitive markets (International Labor Organization, 1972; see also *World Development*, 1978; Sethuraman, 1981), will emerge as a response to the inabilities of the formal sector (which has reciprocal characteristics) to provide employment for the surplus of available labor. The formal private sector becomes involved in rent-related activities on at least two levels. First, and most obviously, formal-sector entrepreneurs will spend a certain amount of their time and resources in rent-seeking activities in order to gain a favorable market position through governmental actions. But formal-sector entrepreneurs will also, perhaps simultaneously, undertake *rent-avoidance* behavior designed to circumvent the *rent-seeking* efforts of the state, either through bribes and similar activities, or by producing or selling their products through informal or illegal means to avoid sales taxes, minimum wage laws, and other such R-S actions by the state. In addition, however, the existence of the whole urban informal economy constitutes a complex but highly rational R-A response to state R-S efforts. Given a labor surplus, low-income workers will find it advantageous to engage in R-A behavior either by setting themselves up in business extralegally or by hiring themselves out to formal entrepreneurs as subcontractors or sales personnel (for example, street vendors), thereby gaining work and avoiding R-S strictures (for example, income taxes).

The formal sector of the urban economy may, of course, not be able to provide the goods or services that the informal sector needs or desires, and the state may (consciously or not) indulge in rent seeking to such an extent that low-income urban groups will find it rational to undertake informal solutions to provide these good or services for themselves. The area of housing is perhaps one in which R-A activities by the low-income populace will be most noticeable—an idea we shall return to later.

The notion of R-S or R-A activities in a Third World urban context provokes a variety of questions and areas for examination. In addition to offering a simple but powerful way of explaining informality in general, rent avoidance can be utilized in discussions of urban land expansion and use, of the emergence of the whole phenomenon of squatter settlements, and of the state's urban reform policies, including squatter settlement policies such as land title distribution.

Low-income housing deserves a special mention here. Low-income urban dwellers may find rent-avoidance activities in providing housing for themselves especially attractive, since entrance into the formal housing market generally depends on stable and predictable employment patterns in order to qualify for and to meet payments on a mortgage. The informal sector by definition is characterized by employment behavior that is frequently temporary and transient, both of which are anathema to formal-sector institutions involved in providing financing for housing. In addition, the formal sector's housing industry may be dominated by monopolistic or oligopolistic firms which, through their own rent-seeking behaviors, can control not only housing construction but also the expansion of the city and its direction(s) of growth. Such control will be advantageous for these firms, but will make the formal market less and less responsive

to the needs of the low-income urban inhabitant whose housing needs (both in terms of type of house as well as its location) will not enter into the calculations of the formal sector.

The model could be amplified and detailed in any number of ways, and we shall return to it as the discussion proceeds. But it is now appropriate to introduce the case that will serve as the empirical referent for the model and that will provide data for fleshing out some of the questions, propositions, and hypotheses that the model produces.

THE INFORMAL URBAN MARKET IN PERU

Scholars and observers of Latin America have traced the roots of the urban informal sector back to colonial and immediate postindependence times, when a labor surplus was already in existence (Bonilla 1974) and when commercial development was strongly influenced by external actors (especially Great Britain), capital, and technology, all searching for external markets for finished products and raw materials for industry. Without going into details here, certain processes and events of the twentieth century (expanded infrastructure and communications networks, the Great Depression, World War II and the Allies' need for the raw materials Latin America had to offer, demographic pressures in the rural areas and resulting cityward migration) exacerbated what had already begun a century or more earlier.

Peru and its capital of Lima comprise archetypal examples of all of these processes. Lima since the end of World War II has grown at least ten times, and the nostalgic vision of Lima as an enclave of modernization and cleanliness and culture and civilized life toward which the rest of the country might aspire has been transformed. As Pennano describes it,

In the last two decades Lima has been Peruvianized. The old phrase that said figuratively "Peru is Lima and Lima is the Jirón de la Unión" [a pedestrian mall in the center of the city famous for its expensive shops and restaurants patronized by the aristocracy] is today truer than ever, but true in reality. . . . If previously the study of Lima or of any other important city in Peru did not reflect the reality of Peru as a nation, today it is not necessary to travel throughout Peru to understand its problems. Misery, crowding, marginality, chaos, disorganization, extremes of wealth and poverty—all are now in the cities (Pennano 1981: 38; translation mine)

As the city has changed, the state (on both national and local levels) has attempted to control that change through a labyrinth of laws, regulations, legislative decrees, and other devices that have affected several sectors of the urban economy, including housing, transportation, street vending, and industry. But such rent-seeking activities by the state did not and have not produced the control the state sought. On the contrary, the emergence of informal and extralegal processes in all of these sectors has instead produced an impotence on the part of the state and a formal economy that depends simultaneously on rent seeking instead of competition to capture a favorable place in the market and on rent avoidance to expand its

productivity and to assure itself of a steady supply of cheap and unregulated labor. Estimates (ILD, 1985:195) that examined three industries in Lima (shoes, clothing, and furniture) concluded that there are (in the 1980s) in Lima about eight thousand clothing and some two thousand shoe manufacturers, 90 percent of which are not legally registered. In addition, at least 85 percent of the fabricators of wooden and metal furniture are also informal; they sell both to the public and to registered enterprises that then put their own factory brands on the finished products. Figures that are equally high also account for bus and taxi services in Lima and, considering that all street vendors are, strictly speaking, illegal or at least extralegal, the estimates that there are probably three hundred thousand individuals (at least 20 percent of the city's labor force) who are either permanent or sometime street vendors provide some rough idea as to the size and importance of such activity for the city and for those who earn their living in this fashion.

The area of housing in Lima needs some elaboration here, since it is the phenomenon that is most readily observable and that has been the target of much research. While self-help and unregulated housing have been a traditional solution for low-income individuals in Lima for many decades (the earliest settlements date from at least the 1920s), in 1961 the Peruvian census reported that only 10 percent of the city lived in officially recognized *barrios marginales* (about 12,000 people). But by 1972 the percentage had grown to 23 percent and the absolute figure to almost 800,000, and 1981 showed the same relationship: 1.2 million people or 25 percent in squatter areas. It should be emphasized that these are official figures from the census; most unofficial but knowledgeable sources today estimate that approximately half of Lima's 6 million inhabitants live in squatter neighborhoods.

Such growth and expansion are commonly cited as evidence of the large rural-urban migration flow that has been directed toward Lima since the 1950s, and it is doubtless true that Lima's growth is owed in substantial part to such movement. Indeed, during the intercensal period 1972-1981, Lima grew by about 400 people per day, 240 (60 percent) of whom were migrants and 160 (40 percent) were city dwellers (Vidal and Cornejo 1983: 53-54). But to blame (or credit) migration for Lima's contemporary problems is to ignore the questions that ask why the city's problems took the form and structure they did. Insofar as housing is concerned, *where*, *when*, and *why* squatter settlements appeared as they did are all questions that are simply not raised by making the simple equation migration = squatters. To go further, it is necessary to describe and to analyze the nature of the urban land market and housing construction industry in Lima.

Lima's growth since World War II has been almost entirely horizontal. That is to say, due to a variety of factors (lack of technology and capital for high-rise construction, fear of earthquakes, availability of unoccupied land, cultural preferences, and so on), Lima has expanded outward, occupying more and more land through urban development that is relatively uncrowded (at least as compared to its own downtown central district, not to mention North American and Western European cities of comparable size). And as this horizontal expansion has occurred, the best areas of the city have been in the hands of private landowners. For instance, up until 1955 only sixty-five large landowners controlled the urbanizable area of

Lima, and of those, the ten largest controlled half of the land and the five largest a third (Calderón, 1984: 105). In addition, about two thirds of these same landowners also owned or controlled major urban development firms, and due to their oligopolistic nature and frequently intimate linkages with financial, economic, and political elites, they were able to decide when they wanted to have their developments incorporated legally into the city and at what price the land and/or houses would be offered. Virtually all such speculation was aimed at middle-income to upper-income buyers.

The power of such groups to control Lima's growth undoubtedly had its costs in rent-seeking behavior which such groups had to endure. But the payoff—the ability to control the direction, pace, scope, and price of the city's growth—was just as undoubtedly worth the cost to the landowners involved. Doing business in this way not only meant very large profit opportunities but also that the low-income population would be left to fend for itself, which it obviously did, as witness the whole squatter phenomenon.

But the linkages between the informal and formal sectors can be far more intimate. Calderón cites the case in the district of San Juan de Luigancho where, during the 1970s, some landowners speculated by holding their previously cultivated land back from the land market while the periphery of the land was being surrounded by squatter areas. Once these areas had become more or less consolidated and the government had installed roads and electricity and had approved water and sewerage projects, these landowners began to urbanize their land, benefiting from the expenditures by the state and efforts by the squatters, both of which improved the value of their land. Calderón notes that in 1975 a speculator had acquired land in the area for S/25 per square meter and sold it in 1983 at S/40,211 per square meter - an increase of 1600 times, far above the inflation rates of the time (Calderón 1984: 105).

Such tactics, while obviously highly beneficial to the owner, extract a major cost from both the state and low-income groups. Holding such land for high prices may drive the urban poor to the far peripheries of the city to search for land and force the state to extend services sometimes to or through speculative holdings, much to the benefit of the speculators.

Until now we have not directly confronted the question of why low-income groups opt for the squatter alternative, but the answer is, in one sense, simple: there are only two options available for low-income groups: either rental housing in a *tugurio* (central-city slum), or self-help housing in a *barriada* (squatter area). Any number of explanations exist as to why these are the exhaustive options for the poor, but the major one is, naturally, economic. A variety of studies of Lima's housing market since the 1960s have all indicated that the construction industry in the private sector is not responsive to the needs of the poor. Riofrío (1978) has perhaps examined this unresponsiveness more closely than anyone else, and while the specific prices and details of his study have changed over time, his general analysis concerning the housing market's inability or unwillingness to provide low-income housing in Lima doubtless still holds. Indeed,

given the economic depression which has weighed upon Peru since the late 1970s, Riofrío's conclusions are probably even more valid today than they were in 1978.

Riofrío's analysis of Lima's real estate market (ibid.: 141-164) begins with a hypothetical family whose head earns S/15,000 monthly and whose wife earns an additional S/10,000 (officially, the average family income at the time in Lima was about S/9500 monthly). There then follow calculations to estimate the price of a hypothetical "minimal house" (not one necessarily found on the market), which is described as a house of 90 square meters (roofed) on a lot of 160 square meters. The price for such a house in Lima in 1978, according to Ministry of Housing and the Peruvian Chamber of Construction regulations concerning "*casas de interés social*," would range from an absolute minimum of S/300,000 to S/715,000. Given this hypothetical estimate, various interviews carried out at real estate offices in Lima concluded that the least expensive housing available in the city at that time was one with 57.5 square meters (roofed) on a lot of 150 square meters. The price for such a house was S/900,000 cash or S/189,000 (20 percent) down and S/15,000 monthly (total payment for the house would amount to almost S/2,000,000). To obtain a loan for such a house, the least expensive money available at that time was a S/900,000 loan, the terms of which required a minimum salary of S/50,000/month and S/15,000/month payment.

These figures, however, need to be understood in the context of overall monthly income distributions in Lima. Table I shows that 90 percent of Lima's families at the time of the study earned less than S/50,000 total family income, the amount necessary for a S/900,000 loan. And the hypothetical family proposed by Riofrío with a monthly income of S25,000 (which in Table I is about the modal family) has, of course, no possibility whatsoever of qualifying for a loan, since the required monthly payments of S/15,000 are equal to the family head's *entire* income. Indeed, as Riofrío points out, more than 20% of the city's families could not qualify for a minimal loan, assuming that their entire income went to pay for the loan (ibid.: 156-57).

Table I
DISTRIBUTION OF MONTHLY FAMILY INCOME
IN METROPOLITAN LIMA (February 1978)

Soles	%	Cumulative %
0-9999	6.6	6.6
10,000-19,999	25.8	32.4
20,000-29,999	30.8	63.2
30,000-39,999	17.0	80.2
40,000-49,999	9.8	90.0
50,000-59,999	5.0	95.0
60,000-69,999	2.0	97.0
70,000-79,999	0.7	97.7
80,000-89,999	0.9	98.6
90,000-99,999	0.5	99.1
100,000 and above	0.4	99.5
No answer	0.5	100.0

Source: Riofrío 1978:155.

As the housing market creates its own very tight strictures for entrance, the state exacerbates these limitations through a variety of rent-seeking activities, again reducing the "choices" of the *masas populares* to the *tugurio* and the squatter settlement. But it is worth asking once again why only *two* alternatives, and why *these* two. To begin to address these two interrelated matters, we can go back to the discussion of what constitutes a rent-seeking state. We defined such a state as one in which state-imposed laws and regulations proliferate to such an extent that rent seeking and rent avoiding both become necessary activities. Hernando de Soto, founder of the Instituto Libertad y Democracia, which has investigated the informal urban sector in Peru for some years, cites two examples of rent seeking by the state that, to his way of thinking, force people to undertake rent-avoidance behavior:

A person of limited resources who would like to build a house on noncultivated land has to choose between obtaining legal permission which will take him between eight and fourteen years or a land invasion that can delay him a week. And as another example, we went to Tampa, Florida, and registered a small business in three and a half hours. In Peru, the same transaction would take 340 days (de Soto, 1984: 75-76; my translation)

