

Case Study on Peru. The Hidden History of the Defeat of the Shining Path – and the Birth of Peru’s New Middle Class

By: Dr. Hernando De Soto

Between 1990 and 2012, Peru’s middle class grew four times faster than the rest of Latin America’s. Why? Because it is an emancipation movement that has been metamorphosing for half a century: From low-income classes to migrants, then to “informals,” the sector from which the new middle class has emerged as the engine of Peru’s impressive economic growth.

The story of how this transformation took place has never been told before. Over the past 14 years, many of the events, reforms and achievements that so many Peruvians lived through -- and died for -- have been forgotten. Quite frankly, we at the ILD were surprised to realize how much we, too, had forgotten about our own role in Peru’s current success story. During the past year, however, we have been refreshing our memories -- by reviewing ILD archives and the files of Peru’s top newspapers and magazines; and by talking to scores of people, including former Peruvian government officials, army officers, and leaders of informal organizations. This article is a preliminary report on what will eventually be a history of the legal, economic, social and political reforms at the genesis of Peru’s rise out of the political and economic ashes of the 1980s. I believe that the facts we are compiling will not just help prevent current and future leaders of Peru from repeating mistakes of their predecessors but also guide reform-minded governments of the developing world serious about ending poverty and creating economic growth -- for all their people.

The story begins amidst events that Peruvians will never forget: a bloody battle with a homegrown, radical Maoist insurgency that called itself “The Shining Path”; with 60% of the country under martial law; upwards of 7,600% inflation; and a drop in GNP of 13.4%. Two successive and ideologically very different Peruvian Presidents pressed for major institutional reforms that resulted in more than a thousand laws and regulations making it easier for informal property holders and entrepreneurs to enter the formal economy. The ILD was at the center of this transformation, nurturing it through boots-on-the-ground research in Lima’s shanty towns and rural villages, reform recommendations and political awareness building efforts that changed how the Government, political parties and the armed forces viewed the country’s poor majority operating outside the law -- not just as Peru’s problem but as a major part of the solution.

Re-categorizing “extralegality” into a social movement with vast economic potential

In the 1980s, the ILD realized that Peru’s street vendors, transport drivers, poor farmers in remote areas of the Andes and millions of other participants in Peru’s huge informal sector were part of a global social phenomenon that continues to this day across developing world -- in Latin America, Asia, the Middle East and North Africa, in the Sub-Sahara and post-communist Europe:

some four billion of the world's population of seven billion, fleeing from small-scale economies (tribal, communal, feudal) toward legal, modernized large-scale economies. Blocked from entering the legal and global markets by burdensome, discriminatory and just plain bad laws, they cobble together hundreds of anarchic and discrete informal arrangements for holding and protecting their property and doing business in what the ILD calls the "extralegal economy."

Why don't governments simply remove the constraints to entering the formal market? Because they do not have an official category that combines the poor with their aspirations to be part of the global market, leaving authorities incapable of identifying the obstacles keeping even the most talented and enterprising among the poor from lifting themselves out of poverty. Why don't economists and security professionals come to the rescue? Because the methods that these experts use to gather and categorize information and extract useful facts are not equipped to deal with this new global reality that the ILD discovered in the 1980s, as communism was imploding -- namely, that the poor were not naturally opposed to Western-style globalization. To be sure, authorities had plenty of information worldwide on the extralegal economy, categorizing people on the basis of such specific characteristics as age, gender, trade and life expectancy. The problem was that though such categories provide a clear enough view of each drop of water outside the legal system, they do not explain how those drops come together into a tsunami threatening the peace and stability of a given country.

That is the reason why governments were unable to explain why Peruvian farmers armed only with spears went to war with the Shining Path or why poor, young Arabs lit themselves on fire and sparked the Arab Spring. It is not surprising that obtaining such knowledge is difficult: "facts" do not exist on their own. In a world brimming with information, facts are the result of selecting and categorizing information properly. ILD has developed categorization principles, protocols and procedures to identify the real constraints blocking extralegals from prosperity while increasing the probability of terrorism, contagious conflicts and the frustrations of poverty that push people into the streets to demand their right to be included in the legal system. Such re-categorization is what is required to reveal the causes of the world's most pressing crises, to remind people that today's crises are similar to those that occurred when the West was making its transition from a traditional to an industrial society, to find out who the West's allies really are, and pave the way for working together to remove those constraints.

What follows is a narrative flashback to how this all began -- by legally empowering a population whose poverty and lack of education had convinced elites that they had zero economic potential. I am telling this story of the birth of Peru's new middle class not only to remind my compatriots of what happened decades ago so that current and future leaders do not repeat the mistakes of the past but also as an inspiration to other reform-minded governments coping with poverty and underdevelopment: If Peru could turn itself from a war-torn economic basket case into Latin America's fastest growing economy with the least amount of violence, other countries can convert their own political crises into growth, too. Here is what happened:

1. **Goodbye to top-down equality.** In the 1960's, Peru's lower classes began abandoning their traditional work among acquaintances and the belief that top-down equality and shared poverty are virtues. They migrated toward expanding markets to cooperate with other Peruvians that they did not know, in the country at large, where climbing up the class ladder is not frowned upon.

2. **Before Chile's economic success and Confiep (Peru's National Confederation of Private Business Organizations).** The migrants traveled mainly to Lima where they proceeded to develop a free market economy, albeit an informal one -- ten years before it happened in Chile and without a dictator. They also rebelled against the "cumbersome licensing process" and demanded a stable currency -- 20 years before Hayek and Friedman visited Lima, 25 years before the formation of Confiep, and 30 years before Peru re-entered the global financial system.

3. **Martyrs of the rising middle class.** In 1981, farmers rebelled against the Shining Path (SP, hereafter), which wanted to collectivize their land and ban markets. SP didn't realize that a large part of land was already private by way of a consensus among the farmers who wanted to be middle class citizens. The SP punished the farmers, killing some 4,600 of them between 1981 and 1983.

4. **First anti-expropriation insurgency.** To defend the values of the emerging middle class against the SP's murderous opposition, some 20,000 farmers from the Andes region of Ayacucho in 1984 illegally organized themselves into "anti-subversive defense committees" (known by their Spanish acronym "DECAS"). Two years later, the DECAS went on the offensive and recovered many of their Andes valleys, forcing the SP to take refuge in the upper highlands.

5. **Second martyrology.** Later in 1986, the SP returned to the valleys, better organized and with major financing. They continued killing peasants, and by 1990 recovered lost ground -- eventually controlling 60% of the country.

6. **Lima misassessed the situation.** At the time, only 15% of the population of Lima believed that the SP would win. Most Limeños were, in fact, more concerned about economic disintegration. For the SP, Lima was only of "complementary" interest and therefore deployed only about 2% of their violence in the capital.

7. **US Assessments:** An analysis by the influential policy organization, The Rand Corporation, concluded that Peru was "on the verge of collapse" and that the "Shining Path could win." The US Department of Defense predicted a possible massacre on the scale of the Khmer Rouge killing fields in Cambodia (almost 3 million deaths).

8. **Farmers assessed the situation correctly.** By 1988, it was clear to the farmers that the root of their problems was the illegality of their organizations. Being illegal in wartime meant that they did not legally merit the protection of the State; they could not bear arms; and thus were

reduced to fighting the SP with spears, slingshots, knives, and some handmade shotguns. Their resentment against the State grew.

9. The category trap. The Government was, in fact, sympathetic. But how could the State form an alliance with illegals? Kant would have defined this as a “category trap” -- i.e. putting two distinct categories on one file card in the official records: “good illegals” (who resorted to illegal means to carry out legal activities) and “bad illegals” (drug dealers, criminals, and terrorists). For Peruvians today it’s clear that the Shining Path –and not the farmers– declared war on Peru; that the farmers wanted to join the legal system while the SP wanted to destroy it; that the good illegals were, as they called themselves, “unread” farmers, while the SP was comprised of well-educated teachers. In the 80s, however, both categories –informal farmers as well as murderous terrorists – were equally stigmatized.

10. Breaking the trap required playing chess -- not checkers. The challenge for the State was to erase the good illegals from criminal records, accepting the fact that in Peru not everybody could become legal at the same rate. The new rules of the game had to include activities that had formerly been punished.

The law of the 80s was like a checkers game, which limits all pieces on the board to one move. A game of exclusion. The farmers wanted to play something more akin to chess, a game in which different pieces can make their own moves. The SP simply wanted to kick over the playing board. Could Peru’s “well-read” society understand that sometimes, when the law loses force, the “unread” can be right? Could they realize that isolating the SP required depriving them of their potential social base?

11. The high cost of playing checkers. In 1983, President Fernando Belaunde created a commission to investigate the murder of eight journalists from Lima mistaken for SP terrorists in the village of Uchuraccay in the province of Ayacucho, high in the Andes, where it had become increasingly difficult to know who was an innocent local, a member of the SP or a self-defense fighter battling the SP. The self-defense committees demanded that formal Peru send them a sign of encouragement, at the very least. The Uchuraccay Report fell short, stating: “Is it possible to make those legal distinctions, clearly and precisely established in our Constitution and laws to men living in such primitive, isolated, and neglected conditions as those in Uchuraccay in the days before the massacre? Is it possible to illustrate, with accuracy and insight, the subtleties of a legal system that, in practice, is often contradicted by their daily practices and traditional community life?”

This conclusion defines Peruvian law as being clear, precise, subtle, and totally at odds with the “primitivism” of the peasants. The report shocked Peru and went around the world, but it also tightened the category trap.

12. Uchuraccay and the advantages of playing chess. Three decades later, the inhabitants of Uchuraccay have proven that nothing about them is “primitive.” A number have risen into the

middle class and are now local entrepreneurs in trade and transport, metalworking, wholesale grain sellers, public officers, radio station owners, and social science professors here and there. Peru's "primitives" now comprise the social sectors that have grown the most over the last few years. In fact, while the GDP per capita growth rate in Peru between 1990 and 2002 was twice that of the rest of Latin America, during that same period, the growth rate of Peru's middle class has quadrupled.

The creation of the new middle class means that sometime after Uchuraccay, the "primitive people" began to break the category trap, that the State put the game of checkers aside; and Peru decided to play chess, and arrange the pieces to put terror in check.

13. ILD enters the story. In 1986, I published "The Other Path" -- an intellectual challenge to the Shining Path, based on the ILD's research into Peru's informal property and business sectors. The book argued that the majority of Peruvians were already operating in a market economy, albeit an informal one. According to the ILD's reform vision, "the other path" out of poverty and toward economic growth was for the government to enact a series of institutional reforms that gave ordinary Peruvians easier access to property and business rights. A best seller in Peru, "The Other Path" rapidly began transforming the national debate about poverty and development.

In 1987, the DECAS -- and President Alan Garcia -- began seeking the ILD's help in earnest. Leaders of the self-defense groups approached the ILD to help them gain legal status. Recognizing that the farmers were part of that poor majority of Peruvians holding their property and businesses "extralegally" -- just like four billion other people throughout the developing world -- ILD concluded that legalizing the DECAS could help defeat the SP -- ideologically and militarily. The President asked the ILD to come up with a strategy to deal with the biggest stumbling block to arming the DECAS: the built in suspicion in international community's agreements with Peru that all its citizens were potential narco-terrorists and its politicians were too inclined to make deals to favor their political or oligarchic interests.

For the next four years, ILD designed and implemented a strategy to re-categorize the DECAS from an illegal force to one accountable to law, based on their long-standing commitment to property and legitimate business. In 1989, the military recognized the DECAS, and Garcia gave them 100 shotguns. In 1990, the three main presidential candidates embraced the ILD reform vision; and by the middle of 1991, with the support of the new government of President Alberto Fujimori, the DECAS were recognized by Peruvian law as well as in nation's covenants with the US and UN. Thus empowered legally, economically and militarily and accountable to the Government, the DECAS' volunteer army of 20,000 fighters rapidly increased six-fold to 120,000.

14. The SP recognized the game was over. SP leader Abimael Guzmán was the first to notice that Peru's re-categorized farmers' organizations were beating him. In mid-1990, he admitted that "the problem may be expressed in terms of an inflexion point... they have taken some areas and pushed us out of them." Every time he entered an area of the Andes, he was confronted and rejected by an emerging middle class that he called "reactionary armed forces by mandate." In

late 1991, the combined forces of 120,000 DECAS and 30,000 Peruvian soldiers renewed the battle for Peru's future and defeated the SP within a year -- both as a military force and a political option.

According to Guzman's further analysis in 1991 in a SP "study document", the hub of the Government's anti-SP strategy was Peru's Anti-Drug Agreement with the U.S., which through international treaties and domestic reforms "... aims against the people's war and seeks to annihilate it... It has been designed and implemented by Hernando de Soto, a direct agent of Yankee imperialism". The SP leader was referring to an inclusion program that the ILD developed between 1988 and 1992, based mainly on what rural and urban individuals and organizations proposed at public hearings. The ILD program consisted in changing the rules so that informals and formals could play in the same game.

15. First move: pawns become bishops. The ILD recognized that to bring the farmers under the rule of law, it was necessary to remove their self-defense activities from the realm of a police matter and restate it as a one of economic development and human rights. ILD publicized the plight of the farmers who gradually won the support of public opinion. And to make the strongest case possible that they were "valid political interlocutors" -- according to the terms of Peru's international treaties -- ILD invited the US Ambassador as well as UN and other international inspectors to visit the conflict areas to get to know the farmer organizations first hand. Recognized as interlocutors, the DECAS were thus re-categorized, thereby allowing the issue of turning them into a legal counter-insurgency against the SP to be raised at the level of heads of state in order to reconcile the status of Peru's informal farmers with its treaty obligations.

The process was carried out in stages until a general consensus crystallized, respected inside and outside of Peru. With precise information on the number of self-defense committees, their forces and their guns, the State was able to instruct the DECAS on what they should do, which reduced their mortality rate by 76%.

16. The second move: Lima, the fish out of water. Between 1988 and 1992, ILD surveyed and talked not only with groups of ordinary Peruvians but also key political leaders eager for reform, and designed a number of measures that the government implemented to allow majority of Peruvians access to the law and state services. ILD also devised mechanisms that gave citizens a voice in government decision-making, including the office of "Defender of the People", a national ombudsman looking out for the public interest.

The result of the ILD's reform recommendations and designs were more than one thousand laws and administrative decisions that made it easier for ordinary Peruvians to formalize their property and businesses. One of those laws alone, the "administrative simplification" act, which Garcia adopted to encourage grievances against bureaucratic obstacles, led to 26 reforms, including the creation of a unified business registry, which the following government implemented, incorporated 388,000 informal businesses into the legal market between 1991 and 1994. These businesses created 558,000 jobs and allowed the tax authority to collect US\$7.8

billion in taxes. The time required to start up and register a business in the city of Lima dropped from 278 days to one, and the cost was reduced by 85%. This simplification initiative was so successful that the World Bank adapted it into the bank's flagship project, "Doing Business."

When Guzmán moved to Lima in 1991 – defeated in the countryside and almost two years before he was captured by brilliant police work– he found that his pool of potential urban recruits were being re-categorized; the class movements of neighborhoods, laborers and other workers that he had created in the informal sector to fan the flames of discontent could not subvert the system. On the contrary: The Federation of Transport Drivers recognized its own entrepreneurial spirit in the ILD's findings and announced it was taking "the other path," and ended their transport strikes. Street vendors sped up the construction of local informal markets, while those whom the Latin American branch of the International Labor Organization (ILO) categorized as "unemployed, unproductive, and without a future" also made their way toward the middle class.



TERRORISM: Blowing up of the EntelPerú power station.

Peru began to recognize its informals as potential members of the middle class after learning -- from the ILD research published in "The Other Path" -- that they accounted for over 60% of man-hours worked; operated 85% of Lima's transportation fleet; that all of their dwellings were private with a replacement value in 1980 of US\$24.7 billion, which in 2013 dollars is equivalent to US\$69.8 billion (12 times the value of the Camisea gas project, Peru's biggest hydrocarbons development effort). They understood that the source of their problems was a reparable right, especially when they learned that the Government Palace, the center of the Peruvian State and official residence of the president, legally belonged to Jicamarca, a poor community in Lima. The impetus to re-categorize the country was so powerful that Confiep initially accepted the proposal of creating a formal-informal union.

On the front page of the SP's daily newspaper "El Diario," Guzmán complained that the ILD re-categorization was "alienating the young from the people's war."

17. The "Gestalt Effect" and politicians. The changes took place during the first Fujimori and Garcia governments, from progressives and socialists. What happened? Did they suddenly discover Adam Smith, get all excited over Bastiat, the 19th Century French economist who inspired modern libertarian economists? What happened was simpler: informals were classified into categories that allowed politicians to identify a new group of potential voters and their expectations.

The rest of the country did not suddenly become liberals, but the war against the SP did make everyone realize that the *status quo* was unsustainable and communism was terrifying. For some time, Peruvians had sensed that we were small or large entrepreneurs, in trading houses or carts, with stamped or unstamped papers. But once we realized that all of our neighbors shared those categories, the desire for change became contagious and irresistible -- and reforms were made quickly. In the 80s, "informality" became a staple in the political conversation for the press, television, and radio. Peru's newsmagazine *Caretas* published an insert every two weeks on the subject, *El Comercio*, the nation's most respected daily, continually published special reports, the popular tabloid "Ojo" published cartoons, President Garcia dedicated three hours to the issue every second Saturday, and Fujimori frequently touched on the subject in TV programs.

Peru's current open economy and the new middle class are the fruits of this policy victory. Its authors are those who gave their lives to defend it, but also those politicians who broke the inertia of the *status quo* and enabled the application of the free market recipes that some of them had fought for 50 years ago, in the face of resistance from various Peruvian presidents who viewed their prescriptions as "politically unfeasible." And they were right: Why would the majority of Peru's people, who according to ILO criteria were "unemployed," support economic 'shock therapy' if it benefitted only the business elite?

Everything changed when politicians realized that the majority of Peruvians identified with the change, which made the prescription for shock therapy feasible. On July 1, 1990 *Caretas* reported from New York on the first accord between the IMF and President-elect Fujimori, noting that the Peruvian side considered "that the market economy does not work for the poor;" and that the Peruvian proposal was made on behalf of the "informal sector and the marginalized."

That is why during the early years of the reforms, for each adjustment measure the Ministry of Finance made, the Government Palace put in place three measures in favor of the excluded. Garcia and Fujimori, with their considerable efficiency and political instincts, approved them. That is the role of heads of state, and it's to their credit; but do not be surprised if they have not fully understood the depth of their reforms.

18. Current controversy over informal mining. The construction process of Peru's new middle class has slowed, as evidenced by the recent huge protests by informal miners – some 500,000 Peruvians whose rights are so poorly defined that 350,000 of them have to bear arms because the Government has failed to protect their legal rights. Some 15 years have gone by since potential members of the middle class linked to the exploitation of natural resources started demanding the legal tools to succeed in the formal economy; while the State, rather than giving them those tools, sat them down at negotiating tables as if they were foreigners, or developed procedures that describe the situation without proposing any solutions, as in Uchuraccay. And instead of letting these people play on the same game board where everyone is categorized in a way that allows them to access credit, capital, and business organizations, the state continues to discriminate against them, breaking them up into different categories, all useless, anarchic, and anachronistic, pitting one against the other and the State: legal, illegal, artisanal, small, medium,

fully and partly informal, with and without registered documents and permits, concessions invaders, concessions informally bestowed, with and without operational requirements, which they sell, paying or not paying taxes, with legal or informal contracts. Add to this the proliferation of legal and political proposals that go against the current legal framework: expropriation and redistribution of the concessions and extension of private property to include the natural resources found under their land.

This entire historical process began when the lower classes stopped working among acquaintances alone and began doing business with strangers throughout Peru. An enormous push came from the first libertarian and farmer movement that defeated the SP and forged the new middle class.

This article does not intend to rewrite history, which is enriched every day through all points of view, a never-ending process. I just would like to call for reflection so that we do not repeat the mistakes of the past: If we provide only a game of checkers instead of a chessboard to those who now aspire to ascend to the new middle class, we will open cracks through which the past can break through.

A plan to re-categorize extralegals in MENA region

Any such step backwards would be a particularly ironic turn of events in Peru at a time when governments around the developing world are eager to solve their own political and economic crises by replicating Peru's success at integrating its extralegal economy into the legal system. As proof, the ILD has received requests for help from 44 reform-minded governments in Latin America, Asia, Africa, post-Soviet Europe and the Middle East and North Africa (MENA), where we're preparing to launch a reform plan this year to re-categorize the extralegals in at least one country and bring them under the rule of law. ILD's MENA strategy has garnered support from the largest business groups in Egypt and the Maghreb, also receiving bi-partisan praise during a hearing on ILD's MENA findings before the House Foreign Affairs Committee; we are also in discussions with the State Department about how we can cooperate in the implementation of our reform plan to re-categorize extralegals throughout the region.

In fact, ILD's pivot to the MENA region began in 1998 -- at the suggestion of USAID Director Brian Atwood, who saw first-hand how quickly Peru's economy was turned around and was convinced that ILD's reform model could help Arab countries. After almost 15 years of extensive research in the MENA region, including the three past years investigating the underlying causes of the Arab Spring, we have concluded that the situation is no different from that of Peru in the 1980s and other countries today in the developing world. ILD's research has revealed that more than 90% of the MENA region's property and 80% of their business assets are mired in the extralegal sector without adequate property and business rights. As a result, extralegal entrepreneurs are unable to extract the full economic potential of their real estate and business assets. For instance, while they can use their houses as immediate physical shelter, they cannot leverage those assets to raise capital through formal credit. While they can do business, they are limited to conducting it in a

low scale, highly inefficient and unproductive way and only within the confines of local circles of friends and acquaintances -- due to their lack of legal mechanisms for dividing labor efficiently and combining assets to maximize their value.

We have concluded that the ongoing MENA revolutions have not been driven by political ideology or religious fervor. What is occurring is a massive economic revolution, resulting from, by our estimate, more than 300 million people fleeing collapsing old economic regimes but unable to enter the legal market that is only available to a well-connected minority. Stuck in MENA's massive extralegal economies with the daily fear of expropriation at the whim of local authorities, they are demanding access to property and business rights. ILD research revealed that not just one but at least 64 poor entrepreneurs across the region lit themselves on fire to protest their expropriation. MENA governments have become increasingly aware of the constraints that extralegality is placing on political stability as well as economic growth. Trouble is, they do not have the agencies or expertise to identify and gather the economic facts required to design reforms to legally empower their poor majorities.

In short, like Peru, MENA is caught in a "category trap." For the ILD, the MENA situation feels a lot like 1990; and, as was the case during Peru's political-economic crisis and battle for political stability, we are ready with a multi-stage strategy to help MENA governments step on "the other path" to peace and prosperity.

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