

ENTREPRENEURSHIP, INFORMALITY, AND THE SECOND ECONOMY: CUBA'S UNDERGROUND ECONOMY IN COMPARATIVE PERSPECTIVE

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In developing countries much of the teeming mass does not consist of oppressed legal proletarians but of oppressed extralegal small entrepreneurs.

—(De Soto 2000: 216)

Instead of the Trojan Horse that will ultimately break down the fortress of “mercantilist” privilege, the informal sector represents part of the routine operation of capitalism as it is presently organized in Latin America.

—(Portes and Schauffler 1993b: 47)

In command economies, informalization is ironically a tool in the hands of urban workers to confront the all-powerful state.

—(Portes, Castels, and Benton 1989: 308)

MICROENTERPRISE, ENTREPRENEURSHIP AND ECONOMIC AND HUMAN DEVELOPMENT

Prior to exploring underground economic activity in a more comparative, theoretical sense, a brief comment on the concept and the nature of entrepreneurship is appropriate. Entrepreneurship has been long recognized as performing a central role in the process of development. Yet the role of entrepreneurship is largely ignored in the main body of economic theory and has received surprisingly little attention in the general literature on development.

Basically, an entrepreneur is one who perceives and seizes an opportunity for the achievement of an objective, who visualizes and plans how the objective can be achieved, and who undertakes to do every-

thing necessary to implement the vision, carry out the project, construct an “enterprise” or organization, and fulfill the opportunity envisaged. More specifically, the entrepreneur brings together all of the resources, inputs, and individuals necessary to implement the project. Presumably an entrepreneur could operate in politics, academia, religion, music, sports, or almost any area of human endeavor. More often, however, the entrepreneur is viewed as participating in the economic arena more so than other areas.

As employed here “entrepreneurship” will refer to entrepreneurial capabilities or qualities, or the ability to envisage, initiate, organize, coordinate, and manage new projects in the economic sphere. Entrepreneurship can be exercised in different varieties of economic system and within the contexts of the private sector, the state sector, mixed ownership sectors, the cooperative sector, and in non-governmental sectors of an economy.

Perhaps the seminal analysis of the role of entrepreneurship in economic development is that of Harvey Leibenstein (1968). In discussing the functions performed by an entrepreneur, Leibenstein identified the following: a “market connecting role” (linking up the potential market for the outputs with the markets for all the relevant inputs); a “gap-filling role” (doing what is not normally or easily done through markets); an “input-completing role” (improvising the provision of all the inputs necessary for the enterprise); and an “enterprise creating role” (bringing to-

gether the inputs for the production of an output over a period of time and in some sort of organization).

The specific activities of entrepreneurs, then, involve a wide variety of things, some of which are clear-cut and others somewhat more abstract. These activities would include:

- Exploring, discovering and evaluating new economic opportunities;
- “Seizing the initiative” to implement a vision and to do everything necessary for its realization;
- Determining, locating, hiring, or purchasing and integrating human and material inputs;
- Establishing an enterprise, managing it, and providing leadership for the people involved in it;
- Structuring and implementing an appropriate incentive structure for people in the firm;
- Bearing uncertainty and facing risk;
- Bearing ultimate responsibility and managing crisis;
- Continuously exploring, learning, evaluating and implementing new production techniques, new input possibilities, and new management approaches.

The above depiction of entrepreneurship is all positive. However, for entrepreneurship to operate in this type of constructive pro-developmental way, the institutional environment, the system of laws, the regulatory environment, and basic political and economic stability have to exist. In pathological circumstances—for example in the absence of law and order, a reasonable judicial system, and political stability—entrepreneurship may also become deformed. In systems with vast and complex systems of regulations and restrictions, entrepreneurs may become preoccupied with rent-seeking of various sorts, all of them relatively unproductive, and they may dissipate their entrepreneurial energies in endless bureaucratic maneuvering and red-tape manipulation. When law and order break down or when entrepreneurial activities are illegal, entrepreneurship may become criminalized, perhaps within Mafia-like organizations. In sum, entrepreneurship alone is insufficient to generate development. Instead, it must

be able to operate within a supportive, legal, and orderly institutional environment.

In the Cuban case, the entrepreneurship that is currently involved in the legal self-employed micro-enterprise sector and in the legitimate underground economic activities constitutes a potential resource that could be of immense value for Cuba’s future. Or it could also continue and indeed intensify its pathological potentialities, remaining deformed and anti-social in a prevailing culture of illegality. The character and future development of Cuba’s own “informal” or “second” economy respond directly to specific government policies and the general economic system in place in the country. What follows then is a detailed comparison of the phenomenon of underground economic activity under the very different economic “regimes” of Latin American capitalism and Eastern European state socialism. We make such a comparison with the aim of uncovering lessons and policy-oriented models with which to better understand and make policy recommendations about similar informal activities in Cuba.

THE “INFORMAL SECTOR” AND THE “SECOND ECONOMY”: AN INTERNATIONAL PHENOMENON

What role and weight should the individual, the household, the micro-enterprise, the local entrepreneur, the state, and national and international capital play in the development process? What kind of legal and regulatory framework best promotes development? What are the ideal “relations of production” between labor and capital to foster development? What is the state’s role in mediating between the interests of capital and labor? Finally, is the notion of distinctly “national” development even possible in today’s increasingly globalized world economy?

On the economic front, the Cold War was a competition between two different answers to the above questions: market versus plan. National development and personal well-being would be achieved through the relatively “invisible” hand of the market (giving free reign to the entrepreneur as an economic dynamo), or alternately, the very visible hand of the state (restricting or wholly outlawing the entrepreneur as an exploitative parasite). On the labor front, workers

under capitalism gradually won protection from market abuse in the form of labor unions and formal labor regulations, while workers under socialism were guaranteed absolute (yet often only theoretical) equality and well-being as citizens. Neither of these promises held true over time and both systems have gradually recreated the unregulated, informal labor relations they had previously outlawed. Over the course of the century, a quiet rebellion for survival by unregulated workers took place within both systems, largely hidden from view or willfully ignored by both policy makers and academics alike. Existing in its majority outside (but not unconnected to) both the market and the plan, this quiet rebellion grew and became known as the “informal sector” or the “second economy.”

Informal economic activity has turned out not to be an anomaly, but an integral feature of modern capitalism, just as the second economy is not an alien element within contemporary socialism, but one of its basic structural features. In both West and East, unregulated economic activity is best understood as a product of the modern and the bureaucratic. Informality is reproduced in direct counterpoint to the “rationalization” and “formalization” of the labor process that has taken place both under market capitalism and state socialism. However, these important parallels do not mean that the “informal sector” (under capitalism) and the “second economy” (under socialism) are necessarily “functional equivalents or structural counterparts” (Stark 1989: 639). In essence, each one coexists with and arises from the contradictions of the dominant mode of production (the formal economy) within which it functions.

In study after study of the informal sector of Latin America, the Cuban case has been consistently, and at times justifiably, excluded (Alessandrini and Dallago 1987; Feige 1989; Portes et al 1989; Schoepfle and Pérez-López 1993; Rakowski 1994; Portes et al 1997). After all, despite changes in its economic profile since 1990, Cuba does not share the economic structure or political system of its fellow Latin American nations (though it does share a common colonial history, culture, and language). Therefore, while taking many lessons from the Latin American ap-

proaches to informality, I explain Cuba’s “second economy” primarily within the theoretical context of the former centrally planned economies (CPE) of Eastern Europe, not the capitalist systems common to the rest of Latin America.

In my understanding of Cuba’s “second economy,” I combine aspects of the normally contrary *neo-liberal*, state-centered and *structuralist*, capital-centered approaches to informality, with the new institutional approach to state socialism described below. Because Cuba’s is a hybrid, “post-socialist” (De la Campa 2000) economy undergoing a transition from a fairly orthodox CPE to an unsure future, with aspects of capitalism, mercantilism, and patrimonialism (Crabb 2001; De Soto 1989), and socialism mixed together, no one theoretical approach fully explains the complexities of the Cuban case.

The “Informal Sector” Debate in Latin America

The informal sector can be defined as that part of the economy where the production and sale of licit goods and services manages to avoid labor and safety regulations, taxation, and official record keeping. Beginning with Keith Hart’s study of small-scale enterprises in Ghana in 1971, economists saw the informal sector as a phenomenon unique to underdeveloped countries. Observers often assumed that the many, often inventive, survival strategies used by informal workers were merely the reaction of poor urban migrants to the many challenges of finding work in major Third World cities. When informal labor arrangements began to appear in immigrant destinations within the United States such as New York, Los Angeles, and Miami, there was a tendency to explain the phenomena as survival strategies brought by new immigrants themselves, not as something integral to advanced capitalism.

Challenging this preliminary assessment, sociologist Alejandro Portes led a multi-country comparative study of the informal economy (Portes, Castells, and Benton 1989), updating its definition and delineating a number of its common characteristics across different world regions. These researchers found that informal labor markets exist not only in the developing countries of the Third World but also in the advanced capitalist economies of the West, as well as in

the then socialist, centrally planned economies of the Soviet bloc. Effectively, this study “revealed the global scope of what was originally thought to be an exclusively Third World phenomenon” (Portes, Castells, and Benton 1989: 2).

The rich variety of activities within the sector share one central feature: they are “unregulated by the institutions of society, in a legal and social environment in which similar activities are regulated” (Portes, Castells, and Benton 1989: 2). The key criteria in identifying informality is not small size, low profitability, or even its common illegality, but the absence of state regulation. This conceptualization of informality identifies as its main characteristic the unregulated nature of its labor relations in contrast to the relatively protected environment in which formal workers operate.

Despite a number of disagreements among scholars about the particular causes, functions, and entrepreneurial potential of unregulated economic activity, there is consensus on the informal sector’s central characteristics:

- It is a process, not a particular product or service;
- It normally operates in cash, “under the table,” and “off the books”;
- It is not simply a set of marginal, last-resort, survival activities;
- It is deeply embedded in and connected to the formal, modern, capitalist economy;
- Labor in the informal economy tends to be “downgraded,” with informal workers typically receiving less benefits and protections than formal employees;
- It possesses a great internal heterogeneity (including owners, managers, wage laborers, unpaid family workers, etc.);
- The sector normally benefits from a government attitude of tolerance (alternating with periodic crackdowns).

Four Theoretical Approaches

Modernization: First developed by U.S. social scientists such as W.W. Rostow, in his provocatively titled book, *The Stages of Economic Growth: A Non-Communist Manifesto* (1960), in the aftermath of World

War II, the modernization approach to national development characterized the underdevelopment of the Third World largely as a “social problem” internal to and caused by the backward socio-economic systems of individual countries (Portes and Walton 1981: 3). Thus, the policy prescription was for them to acquire “modern” values geared toward achievement, “modern” legal institutions and political systems, and “modern” capitalist economies. In most cases, the “modern” was understood as being synonymous with western values, institutions, and market economies.

In essence, the problem of underdevelopment (and by extension, informality) was not one of capitalist exploitation and extraction (as argued successively by neo-Marxist, dependency, and world-systems theorists) but that these countries had not yet been sufficiently incorporated into the modern world or the international economy. It was only a matter of time (through foreign aid and development programs such as USAID, the Peace Corps, etc.) that these countries would “take-off” and “catch-up” with the developed West.

In line with this patronizing prescription for national development, modernization theory saw the informal sector as a remnant of traditional, pre-capitalist modes of production and subsistence strategies common to isolated rural peoples. Informals were trapped outside the modern economy because they lacked the proper education, skills, and value-orientations. The informal sector, therefore, was not an area of economic growth or dynamism, nor was it characterized, as it often is now, as a reservoir of entrepreneurial training and talent. It was seen as a problem to be solved not a development strategy to be harnessed and promoted.

Dependency: It was Keith Hart’s pioneering work among informals in Ghana (1971, 1973), combined with studies of informality in Kenya published by the International Labor Organization (ILO 1972) that crystallized the phenomenon of unregulated economic activity into the term “informal sector.” Hart’s contribution had such a broad and original impact because he focused on the complex, organized, and dynamic income generating activity of in-

formal enterprises. In effect, he found that informal activities were not a mere extension of traditional subsistence strategies and that participants in these unregulated activities were not universally condemned to poverty and marginality (Hart 1971, 1973; Portes and Walton 1981; Portes and Schauf-
fler 1993b).

However, other scholars working within the dependency tradition have all too often made the mistake of characterizing informal workers as universally poor and emphasized the sector's supposed marginal position vis-à-vis the modern capitalist sector (Portes and Schauf-
fler 1993b). Furthermore, in place of developing a systematic definition of what constituted informality, practitioners of the dependency approach (Tokman 1978, 1990; PREALC 1978) often simply described the many common characteristics of enterprises in the sector: little capital, low technology, production, and profits, utilization of unpaid family labor, easy entry, and high efficiency and competition. Moreover, the dependency approach saw the goal of informal operations as mere survival, not profit maximization. Informal firms were often characterized as taking advantage of their ability to avoid taxes and regulations and exploiting niche areas overlooked by larger, less flexible firms (Tokman 1990).

Dependency theory saw the informal labor arrangement as taking place largely outside of the exploitative formal relations of production. Thus, the informal sector was viewed largely with suspicion as a mere transposition of the rural subsistence sector into the urban environment. The dependency approach to informality can be summarized as: "The condition of the 'marginal mass' is one of disarticulation from the dominant economy and of autonomous attempts at survival through a myriad of interstitial economic activities" (Portes and Walton 1981: 78).

Neo-liberalism: Peruvian economist Hernando de Soto caused a paradigm shift of sorts when he published his treatise on Latin America's informal sector. Tellingly titled, *The Other Path: The Invisible Revolution in the Third World* (1989), De Soto's best-selling book characterized the informal sector as a popular revolutionary movement. Contrasting it with the Shining Path, Peru's own then powerful Maoist

guerrilla army, De Soto argued that Peru's non-violent informal army was led by the excluded masses of poor urban migrants to Lima. He further characterized the informal sector as a popular reaction to over-regulation of the economy by an essentially patrimonial, mercantilist (not truly capitalist) and corrupt state apparatus.

De Soto can be credited with turning the informality debate on its head and bringing it out of the academy into public view. Finally, it seemed, Latin American governments, NGOs, international financial institutions, and even the normally aloof U.S. government was willing to pay attention to an issue that had been largely restricted to academic inquiry and theoretical debate for 15 years. According to many other scholars, however, the large amount of attention De Soto's ideas received was due to the fact that his book coincided with major political and economic changes in Latin America and the world at large and because the classical liberal ideological basis for many of his ideas was already dear to many Western conservatives, whose ideas are known collectively as the "Washington Consensus."

Along these ideological lines, De Soto argues that Marx himself would be surprised to find that, "In developing countries much of the teeming mass does not consist of oppressed legal proletarians but of oppressed extralegal small entrepreneurs with a sizeable amount of assets" (2000: 216). He therefore advocates transforming the "class struggle into a struggle for popular initiative and entrepreneurship" (1989: 255). Essentially, De Soto argues that the masses have united in a revolutionary front not as proletarians against capitalist exploitation, but as extra-legal, micro-entrepreneurs against a bureaucratic, state-directed economy that excludes them from becoming full capitalists themselves.

Locked out of formal jobs and denied formal, legal title to their property, they proceeded to create their own micro-enterprises and institute their own set of occupational-specific extra-legal norms and regulations. In fact, his most original contribution to the informal debate is his almost unqualified celebration of the informal sector as the Third World's "real capitalists" forming its "real economy." He makes grand

claims that the informal sector has the potential not only to create wealth, reduce costs, and democratize politics, but also to push out and replace the first economy. Thus, in comparison to other scholars who see informal economies of growth as exceptional, de Soto contends that the informal sector is filled with revolutionary potential. To his credit, De Soto does recognize and describe the many “costs of informality.” Avoidance of detection, working on a small-scale, bribery, reliance on unskilled labor and low-technology production, and the inability to trust in investments or enforce contracts all act as indirect taxes in the quotidian struggle of informals (1989: 131–187).

Whereas his first book seems to argue that all regulations should be thrown aside to accommodate the informals, his second book, *The Mystery of Capital* (2000), makes the more realistic demand that erroneous and archaic legal regulations be changed to allow entry to informals—effectively making the “costs of formality” less than the “costs of informality” (2000: 154–170). De Soto characterizes the status quo in many supposedly capitalist countries of the Third World and Eastern Europe as one of “capitalist apartheid”: privileges are granted to a small, well-connected elite while the majority remain excluded from legal participation in the formal economy. Kept outside of what De Soto calls the “capitalist bell-jar,” informals avoid regulations and taxes but are forced to endure many other hidden costs.

Structuralism: Structuralists insist that informality is not simply the result of excess labor supply on the one hand or over-regulation on the other. Instead, the central element of the structuralist approach is its insistence that informality is in essence an alternate form of labor utilization (and often exploitation) by capital. Put differently, informal labor relations (like informal workers) are not “just there” by some accident or flaw in capitalist development. Instead, these relations (and workers) are actively “informalized” by capital under the logic of peripheral capitalist accumulation.

Structuralists have argued that the “novelty” of the informal sector is largely illusory. What is new in the production process is not informality, but formal la-

bor relations themselves. Labor relations in the late 19th century were characterized by paltry or non-existent protections and benefits for workers. Informality only came into existence as a distinct category in the production process after its antithesis, the formal, relatively protected worker, was created through years of struggle by labor unions. What is a “new” phenomenon is the active *re-creation* and *intensive utilization* of informal labor relations by formal capitalist firms. This is identified by structuralists as a novel strategy in the economic restructuring of global capitalism in reaction to the structural crisis that began in the early 1970s.

The single most important contribution of the structuralist approach to the understanding of informality is the contention that deep and necessary linkages exist between the informal sector and the larger capitalist economy. Portes and Schauffler have labeled their approach “structuralist” because they emphasize the complex and heterogeneous “structure of formal-informal relationships” (Portes and Schauffler 1993b: 48). Elsewhere, these same authors have gone further, saying, “formal and informal activities are simply *alternative facets of the same economy* and their articulation adopts a ‘variable geometry’ depending on the scope of state regulations, the requirements of capitalist firms, and the size and characteristics of the labor force. This *articulation between both sectors* is the core of the structuralist approach” (1993a: 25, my emphasis).

Portes and Schauffler have identified three key ways in which the existence of the informal sector is closely linked to the formal sector of the economy. First, informal enterprises supply a host of low-cost goods and services to formal workers, allowing them to more effectively “stretch” their often-insufficient salaries. Second, the presence of these thousands of informal micro-enterprises acts as an indirect subsidy for capitalist enterprises since they can more easily justify paying what would otherwise be unacceptable wages. Third, the informal sector aids in the functioning of the capitalist economic system as a whole as it provides formal firms an easily disposable source of unprotected workers. In other words, these firms can “reach down directly into the informal labor

pool” when deemed necessary (Portes and Schauffler 1993b: 48–49).

In contrast to De Soto, Portes and his colleagues argue that, “Instances of informal economies of growth are clearly exceptional and do not justify the celebration of ‘flexible specialization,’ enclave economies, or small-scale export production as generalizable solutions to economic underdevelopment” (Portes, Castells, and Benton 1989: 302). Though very exceptional, a number of common characteristics of “informal economies of growth” have been identified by Portes, Castells, and Benton (1989: 302–306).

First, they cite the well-known example of the Italian region of Emilia-Romagna where access to and adaptation of *imported production technology* allowed informal enterprises to enter an upscale market instead of concentrating on the production of low-technology consumer goods as is typical for most informal producers. Second, they identify the production of *higher-end export-orientated items* as a key to success in a number of case studies. Third, instead of being locked into a dependent subcontracting relationship with a capitalist firm, most informal economies of growth have exercised *relative autonomy* in the production and marketing process. Finally, the authors argue that cases of informal success have also shared the triple advantage of taking place (1) with government support, (2) in an entrepreneurial environment, and (3) making use of a specific socio-cultural context where strong bonds of solidarity already exist.

Discussion

In summary, if the dependency approach focuses on the inability of capital to absorb labor and provide it with protections, and the neo-liberal approach sees informality as an antagonistic struggle between entrepreneurs and the state, then the structuralist approach sees informality as the result of the complex and ongoing class struggle between capital and labor, where capital has successfully evaded state regulations by actively creating and/or taking strategic advantage of a “new” type of labor: the unprotected informal worker.

The neo-liberal and structural theoretical approaches are usually seen as polar opposites. However, as seen from contemporary Cuba, the second economy under state socialism is one of the rare instances where the neo-liberal approach utilized by de Soto comes together with the structural approach employed by Portes, since they both focus on the power dynamic that exists between informal, underground workers on the one hand and the state/capital nexus on the other.

As a political system, state socialism is far from being a mirror image of the mercantilist nations of the past. However, as systems of economic organization both state socialism and mercantilism tend toward the same bureaucratic, paternalistic control over all economic activities under their “domain.” Whereas mercantilist nations exercised a monopoly over international trade and severely limited the development of local markets, state socialism has exercised its control through establishing a monopoly on ownership of productive forces and universal state employment (Rona-Tas 1997). Still, unsanctioned entrepreneurial activities run the same risks and provoke the same official condemnation under both systems. The ubiquitous informal private entrepreneurs that were once the lifeblood of the “hidden economies” of the Soviet Union and Eastern Europe (and continue to proliferate in Cuba) bear a striking resemblance to both De Soto’s informal “heroes” of today and the ubiquitous contrabandists that once populated the underside of the mercantilist economic structure during Latin America’s colonial period.

Likewise, the systematic utilization of the informal sector by formal capitalist firms described by Portes finds a strange counterpart in state socialism’s systematic reliance upon the second economy to make up for its own inefficiencies and contradictions. However, whereas the second economy can be seen as essential to the proper functioning of state socialism (in many instances becoming the true, if hidden economy), informal economic activities are typically much more modest and limited in capitalist systems. Still, the existence of a flexible second economy (providing employment and efficient production) within the official planned economy provides state socialism

with a very convenient, if potentially corrosive, subsidy. Furthermore, as with the structuralist version of the informal sector, this subsidy is provided through the active (self-) exploitation of a large part of the workforce. In other words, an important, if largely unintended consequence of widespread private entrepreneurial activity is the preservation of a flawed state socialist system.

If we can characterize Cuba's current economic system as passing from an orthodox form of state socialism based on a central plan, to one of "market socialism" or "state capitalism" based on a relatively "open" economy in terms of joint ventures and foreign investment (but closed in terms of the great restrictions on private citizens' participation in the state controlled markets), then the benefits provided the state by an active second economy are clear. In this way, the different theoretical models developed by neo-liberals and neo-Marxian structuralists to explain the causes and functioning of the informal sector in the Latin American context can help explain the origin and functioning of Cuba's own second economy. However, since these models are derived from the unique socio-political context of capitalist Latin America, they ultimately fail to grapple with the structural, systemic, and institutional realities that have provoked extensive underground economies and black markets in all historical examples of state socialism. We now turn to this history (and theoretical literature) in order to synthesize a model that can better explain the Cuban case.

The "Second Economy" Under State Socialism

While Portes and his colleagues reject De Soto's belief in the "revolutionary" potential of informal workers, they do recognize the special nature of informal work (the second economy) under state socialism. "In command economies," they write, "informalization is ironically a tool in the hands of urban workers... to confront the all-powerful state. In certain national instances..., the informal economy has proven strong enough to compel state managers to gradually yield to its logic" (Portes, Castels, and Benton 1989: 308). Because the "triangular relationship between capital, labor, and the state" (Portes, Castels, and Benton 1989: 309) has been in-

stitutionalized under very different terms in state socialist societies, unregulated activities in CPEs arise from distinct causes and are not functional equivalents to the informal labor relations of the West.

Under dependent capitalism, informalization is a strategy employed by formal firms in order to expand their profit margin by avoiding formal labor laws. Thus, in Latin America informality commonly "serves to strengthen the hand of the dominant class and to weaken labor's organizations" (Portes, Castels, and Benton 1989: 309). In contrast, under state socialism informalization is carried out by workers themselves in order to win a greater return on their labor output than is common under employment in state jobs. Therefore, the functional equivalent in the West of socialism's "second economy" is not the informal sector but actually the trade union (Stark 1989). Though not institutionalized and legally protected as is the trade union, the second economy functions to protect workers from arbitrary abuse by the "dominant class" (state firms and the party) and provide them with the supplemental wages they are denied as workers in the first economy.

As with the initial theoretical approaches to the informal sector in Latin America, early interpretations of the phenomenon of the "second economy" in Eastern European socialist states characterized it as a "throwback" to the traditional, non-industrialized past. Essentially, the second economy was seen as a marginal holdout from the capitalist past that would soon disappear or have to be eradicated. However, as with the informal sector, the second economy of socialist states can be correctly understood as a functional requirement of state socialism.

In his groundbreaking essay, "Bending the Bars of the Iron Cage: Bureaucratization and Informalization in Capitalism and Socialism," David Stark (1989) argues that while informality often manifests itself as an effort to circumvent regulations, it is essentially congruent with the same market principles (production for private profit) that coordinate formal capitalist economy. In contrast, the second economy, while responding to the contradictions of socialist redistributive bureaucracy, responds to market mechanisms that are *fundamentally incongruent* with the re-

distributive principles of the state. As such, the second economy is an antagonistic source of systemic change, constantly applying pressure to remake the economic institutions of socialism. The second economy in socialist states “represents a counter-economy and not just a sub-economy” (Los 1987: 55).

In such a context, the second economy represents much more than a mere supplementary alternative to the state sector. In quiet revolt against the desire of the state to control all markets, the second economy represents an antagonistic alternative. Its existence expands the space available to workers beyond the state-controlled realm, effectively freeing them from exclusive dependence on state wages. Whereas under capitalism informal workers are often worse off vis-à-vis officially employed and protected formal workers, under state socialism the earnings of underground workers are often higher than those of state workers (Stark 1989: 655–656). This advantage vis-à-vis formal, state sector jobs is a key characteristic that distinguishes Cuba’s “informals” from their informal counterparts in the rest of Latin America.

Defining the Second Economy: The term “second economy” is used to describe those economic activities in socialist economies neither regulated by the state nor included in its central plan. While these unregulated activities often make up for the state sector’s lack of economic efficiency, second economy activities have more than a merely economic meaning and as such are not normally encouraged (though they are often tolerated). Even when legal, licensed, and taxed by the state, such activities are often seen as a threat to the monopoly of central planning since they provide a modicum of economic freedom to their participants and cut against the ideological grain of full state ownership, labor solidarity, egalitarianism, and universal state employment. For this reason, the legitimacy of the small private sector is frequently under attack and entrepreneurs commonly find themselves caught in a cycle of periodic suppression and accommodation. Finally, unlike the informal sector under capitalism, the limits of which are set by legal criteria, the second economy under state socialism is defined by both legal and *ideological* criteria.

Grossman began giving systematic scholarly attention to the unregulated economic activity common in CPEs in the late 1970s with a seminal article on the second economy of the Soviet Union. He defined the second economy as those productive activities which meet at least one of the two following criteria: (1) they are to a large extent carried out in knowing violation of existing laws, and/or (2) they are directly engaged in for private gain. Thus, the key difference between the informal sector as it exists in Latin America, and the second economy within CPEs is one of *legality* versus *control*. In other words, the second economy expands the concept of informality to include not only economic activity that is illegal or unregulated by the state, but also all private profit-driven activities (legal or not) which contradict the socialist ideals of egalitarianism, state ownership of the means of production, and universal state employment.

Portes and Böröcz echo this basic distinction between informal and second economy activities. They argue that in both capitalist and socialist systems informal activity takes place “outside the scope of public regulation” (1988: 17). However, because informal activity in CPEs defies “the channels of central planning and direct state control” it becomes a “terrain of political struggle per se” (1988: 19). Furthermore, Portes and Böröcz make an important modification regarding the essentially *licit* nature of the goods and services produced in the second economy. Whereas Grossman needlessly includes all illegal activities, Portes and Böröcz make the distinction that the second economy properly includes only the “production and distribution of licit products” (1988: 19) that take place outside the state’s central plan.

In her attempt to put specific definitional limits on the second economy, Los (1990) also rejects exclusively legal criteria as too narrow and moral criteria as too relative. She opts instead for an ideological definition: “the second economy includes all areas of economic activity which are officially viewed as being inconsistent with the ideologically sanctioned dominant mode of economic organisation” (1990: 2). This ideological criteria would specifically exclude illicit goods and services such as drug trafficking and

prostitution, but include both the illegal theft and resale of state goods (cigars) and formally legal but ideologically questionable activities such as licensed self-employment (e.g., bed and breakfasts, private taxis, and paladares).

Causes of the Second Economy: State socialist systems are characterized by the presence of three principal institutional structures: (1) *state ownership* of the means of production, (2) economic decisions being dictated by a *central plan*, and (3) the concentration of labor under *universal state employment*. Together, these three structural dictates are present in all historical examples of state socialism and their rigidities provoke the necessary existence of a second economy (Róna-Tas 1997).

State control over the means of production is one of the central elements of state socialism. However, such an abstract notion of state ownership has led in practice to the misuse and theft of state supplies, often done with little social stigma. In fact, preferential access to state supplies is often understood as one of the few “informal rights” of state employment. Thus, under state ownership, workers are not inclined to remain in state jobs because of their wages, but more commonly motivated by the access those jobs give them to state goods.

Likewise, the abolition of supply and demand gives rise to the need for an alternative form of product pricing, wage scales, and resource allocation and distribution: the central plan. However, unlike market allocations, central plans tend to be set administratively and arbitrarily. This has led to chronic shortages, production bottlenecks, and low quality products. Instead of aiming at efficient production based on profitability, the logic of central planning is the fulfillment of production quotas at any price and with little attention to efficiency, profitability, quality, or consumer preferences. As a result, use of the central plan results in under-employment (workers employed, but underutilized), lack of motivation, ab-

senteism, wastefulness, and the use of informal mechanisms by managers in order to meet quotas.¹

Perhaps because universal employment is often seen as a desirable but unattainable goal under capitalism, most scholars have been slow to recognize its function as a means of social control and system stability under socialism. However, universal employment is primarily a means to ensure social order through “a complex, nationwide system of organized dependence whereby one’s supervisors were entrusted not only with the enforcement of hard and productive work, but also with chores of imposing political control” (Róna-Tas 1997: 4). Effectively linking one’s health, pension, and other social benefits to one’s livelihood, and in turn linking that livelihood to participation and complicity in the socialist system “allow[ed] the Party-state to exercise power through its ownership rights rather than through coercion” (Róna-Tas 1997: 4). However, when workers are able to break free from this system, one of the state’s principal means of control is compromised, explaining why the socialist state feels constantly menaced by the growth of even small-scale private enterprise.

Grossman has rightfully indicated that unregulated economic activity is found to different degrees in all societies. He argues, however, that a socialist society “possesses nearly every favorable condition for the appearance of a large illegal economy and the corruption of officialdom” (1979: 843). Growing out of the three structural institutions of state ownership, central plan, and universal state employment, specific elements make state socialism “fertile ground” for the growth of a second economy. Extensive price control, the prohibition of private activity, high self-employment taxes, unsatisfied demand, impersonal property under inadequate custody, the personal power of many government functionaries, and an acute need for many goods and services all create structural pressures, opportunities, and substantial rewards for private initiative (Grossman 1979: 842–847; 1989: 152–153).

1. These chronic problems have given rise to the ironic quip that, under socialism, labor and management have reached the peculiar agreement: “We pretend to work, and you pretend to pay us.” This discussion of state ownership and the central plan and draws heavily on Pérez-López (1995: 16–19).

Differing Theoretical Approaches to State Socialism and the Second Economy

The relatively sudden and largely unexpected collapse of the entire state socialist bloc of Eastern Europe between 1989 and 1991 was followed by much theoretical soul searching among scholars who had studied and supposedly understood these societies. Few if any of them would have predicted such a sudden and seemingly complete implosion of what were purported to have been relatively stable if deeply flawed socio-economic systems. Ironically, the very same factors that had once been cited as reasons for regime stability were later hastily identified as the causes of regime breakdown (Róna-Tas 1997: 3).

However, a small group of Eastern European economists and sociologists (working within the state socialist countries of Eastern Europe) had begun shedding light on the extensive internal corrosion of state socialism well before the end finally came (Nee and Stark 1989). Whereas Western scholars largely assumed that the socialist “suit of armor” was home to a fierce and fearsome knight, many Eastern academics were well aware that the knight inside had long since died. These social scientists were later joined by a group of Western academics, calling themselves the “new institutionalists,” who together placed the *economic institutions of state socialism* at the center of their analysis.

Essentially, in place of ad hoc explanations of the demise of state socialism, these researchers sought to develop an adequate theory of social order in state socialism. If they could explain how such a system was able to hold together over such a long period of time, they could also pinpoint the processes that led to its ultimate undoing. These scholars have insisted on approaching state socialism on its own terms. For the new institutionalists, the “ground rules” of any valid approach to state socialism must take into account the “institutional arrangements” particular to socialism, and go beyond a focus on Party-state elites to include the multiple interactions between subordinate groups and the state. In other words, the new institutionalist approach understands socialism as neither monolithic nor static, but as a “hybrid version of socialism that accepts practical compromises and mu-

tually contradictory principles as a given condition of social life” (Stark and Nee 1989: 31).

Totalitarianism, Modernization, and Interest Group Theory

Traditional theoretical explanations of the “stability” of state socialist systems began with totalitarianism. Essentially, totalitarian theory understood communist regimes as the polar opposite of Western democracies. Whereas social order in the West is based on fundamental freedoms, rights, and the pursuit of individual self-interest, in state socialism stability is the result of coercion, control, and omnipresent fear. Totalitarian systems are by definition based on the absolute rule from above by a unified party. The simple beauty of the totalitarian model was that its proponents had no need to bother with actually studying and understanding the internal workings of the Soviet system.

Historical experience eventually led to the partial displacement of this facile version of state socialism. The initial economic growth and impressive industrial progress achieved by the Soviets led to a more nuanced and qualified understanding of state socialism. The modernization approach found that both capitalism and socialism shared extensive levels of bureaucratic and industrial organization. While organized within an ultimately inferior economic system (due to its inherent inefficiencies and chronic scarcities), state socialism reflected the same general organizational and bureaucratizing tendencies of the modern movement toward a logical organization of production on a large scale with the use of modern industrializing technology. Modernization theory concluded that, in order to maintain its economic growth, such a bureaucratically organized industrial system would eventually be forced to throw off its socialist character. While total control was the intended plan, industrial organization had had the important consequence of increasing bureaucratization, which was seen as a fundamental prerequisite on the path to modernity (Stark and Nee 1989).

Another challenge to totalitarian theory, pluralist or interest group theory, recognized the existence of different elite groups within the socialist state hierarchy whose interests are often in conflict. Contrary to the

claims of totalitarian theory, the interest group approach to state socialism flatly rejected the image of a monolithic party devoid of all internal conflict. In fact, interest group theory sustained that when all political activity is subsumed within a single political organization, conflicts that would normally take place across party lines would not cease but simply become more concentrated and perhaps even more intense, taking place among the internal factions of the same party. Thus, in explaining the origins of change within state socialist regimes, this approach focuses on conflict among a variety of elite, powerful groups within state socialism (Stark and Nee 1989: 6).

New Institutionalism

In place of pluralist theory's exclusive focus on elite interest groups within the state bureaucracy, "institutional analysis examines the activities of subordinate social groups within society." Stark and Nee argue that "whereas the totalitarianism school attributed primacy to parties and ideology and the modernization school saw technology and values as the keys to explain modern development, the emerging framework focuses on institutions and social groups" (Stark and Nee 1989: 8). By focusing on the economic institutions of socialism (state ownership, the central plan, universal state employment, party-state control of the allocation of good and services, etc.), the new institutionalists pinpoint the locus of power within communist regimes. "Power comes from de facto party ownership of productive assets and organized monopoly over allocations of goods and career opportunities" (Walder 1995: 6).

If near total state control over these resources is the key to political power, then it would follow that, "Party loyalty and authority [are] founded upon citizen dependence upon officials for the satisfaction of material needs and access to career opportunities" (Walder 1995: 6). Finally, system stability arises not from conviction, loyalty, or fear (as totalitarian theory would have us believe), but from individual self-interest in a controlled environment, reinforced by the scarcity of alternative sources of goods, services, and income. Thus, any changes to or breakdowns in social order in such an environment would necessari-

ly come about as a result of shifts in the economic dependence and incentive structures of different social groups.

COMMUNISTS WHO LOVE THE MARKET AND ENTREPRENEURS WHO HATE IT

If the second economy is indeed a wolf in sheep's clothing threatening the stability of the socialist system, why did nearly all pre-1989 socialist states of Eastern Europe enact economic reforms, creating legal space for the second economy that ultimately undermined their own power? Furthermore, if communist "cadre entrepreneurs" can learn to love the emerging market because it provides them with lucrative positions of power as "nomenklatura capitalists" (Walder 1995), so too can private entrepreneurs learn to hate the market, preferring the former unregulated system where hard-won favors and special connections provided a stable source of protection and privilege (Gabor 1994). Thus, two of the most significant unintended consequences of economic reforms within state socialism are: (1) the creation of a whole class of self-employed entrepreneurs who were less and less dependent on their state jobs for survival; and (2) the gradual "corruption" of state agents and party cadres for whom the opportunism and self-interest of the market came to predominate over and provide greater rewards than loyalty and commitment to the Party.

The Growth of Worker Independence

One of the central reasons that economic reforms ultimately weaken the party's authority is that such reforms can strengthen the position of proto-entrepreneurs who operate in the second economy. In fact, the growth of the second economy has the unintended effect of turning dependent "subjects" into relatively independent "brokers." More than any other socialist institution, universal state employment performed the necessary function of co-opting and making the bulk of society complicit in the system. However, activity in the second economy allowed workers to develop a modicum of leverage and independence with which to confront state employment. Thus, whereas informality under capitalism is often a tool used by employers to better control and discipline labor, the second economy in Marxist states is one of

the “ways in which economic agents remove themselves from the socialist state’s control mechanisms of planning, record keeping, taxation, and regulation” (Schoepfle and Pérez-López 1993: vii).

Understanding the political role of universal state employment under socialism allows us to identify much more clearly the corrosive effect of the rise of the private sector (as an alternative labor market) in a socialist context. While the second economy compensates for the first economy’s deficiencies in the short-run, it also fundamentally undermines the primary means of control and social order within a socialist system: universal state employment. When citizens cease to depend upon the state for their livelihoods, they are no longer implicated as complicit beneficiaries in the socialist system and therefore possess a potentially powerful form of freedom and independence.

Cadre Entrepreneurs

Alternative sources of power and privilege available to non-state actors are also available to the very state agents who are relied upon to enforce economic laws. With their loyalties increasingly divided, party cadres of Eastern Europe increasingly opted for opportunism over commitment. In explaining why “communists come to love the market,” various scholars have pointed to the “path dependence” of reform under state socialism. In short, once limited reforms are enacted and parts of the second economy are made legal, the state enters a new terrain where citizens begin to make demands for more reform and state agents become accustomed to the new infusions of income that an increasingly mixed economy provides them.

Once reforms are begun, further reform is the product of pressures originating both outside and within the state apparatus “forc[ing] the state [...] to tolerate activities that were once illegal but not yet legalized, and to institutionalize reforms that were legal but were not yet legitimate” (Stark 1989: 652). Therefore, the growth of the second economy is not simply a case of state against society. It is also evidence of a lack of integration within the state itself. The state cannot scale back reforms if its main constituency, party cadres, benefit from and rely upon them. These cadres need not be consciously anti-gov-

ernment and are often far from being political dissidents. Instead, they are naturally self-interested in an environment of scarcity.

It is often forgotten that the underlying goal of economic reforms in socialist states has everywhere been the same: to perfect and preserve socialism. Given this aim, economic reforms in Eastern European socialist states have been a failure and the role of the second economy has been clearly subversive. In light of this history, the reasons behind Castro’s open rejection of the reform path taken in Eastern Europe are more understandable. Reforms (1) accomplished few of their original goals; (2) destroyed leadership’s control over labor; and (3) deprived the party leaders of a social base (Róna-Tas 1995).

CONCLUSION: SUMMARY AND LESSONS FOR CUBA

Unregulated economic activity originates in relation to the dominant mode of economic organization in any given society. For this reason, models developed to understand the Latin American informal sector (dependent capitalism) cannot fully explain the Cuban case. As was the case with the second economies of Eastern Europe and Asia, unregulated economic activity in Cuba takes place in a socialist context of central planning and against that dominant ideal. Though each of the theoretical models developed to understand the rest of Latin America shed light on the Cuban case (especially given the common historical and cultural heritage across the region), none captures the Cuban reality as well as the theoretical models developed for the state socialist context because of the depth and breadth of the socialist political and economic system instituted in Cuba during the 1960s and 1970s.

Specifically, we can take from De Soto the neo-liberal contention that a major cause of informality is an overbearing, monopolistic state. This perspective parallels the new institutionalist theoretical paradigm developed in relation to Eastern Europe’s experience of socialism. This paradigm stresses the importance of understanding the complex and conflictual inner-workings of socialist institutions on their own terms. Finally, though it would seem to clash with these two state-centered approaches, the structuralist school’s

focus on capital's use of informals through subcontracting arrangements is analogous to the monopolistic socialist state's reliance on workers in the second economy to "resolve" the inefficiencies and bottlenecks common in CPEs.

In fact, in today's Cuba the nominally socialist state commonly provides foreign firms (operating on the island and abroad) with "disciplined" Cuban workers through subcontracting arrangements. These firms pay the Cuban government directly in dollars, while workers receive a peso wage from the state worth just five percent of the contracting fee. While these workers remain "protected" in the sense that they receive in kind benefits from the state in the form of free education, health care, etc., they are still being used by the monopolistic state apparatus with the purpose of capturing greater amounts of hard currency. Such a labor mobilization system is not unlike the profit maximization strategies of transnational corporations operating in the rest of Latin America.

While there is a fair and growing amount of insightful literature about Cuba's private sector, only a handful of researchers have gone beyond insightful description and attempted to tackle the Cuban conundrum within a comprehensive theoretical framework. Among these, Pérez-López and perhaps Rivera (1998) are unique in applying to Cuba the models of the "second economy" as originally developed in the Eastern European context.

Building on the "new institutionalist" approach to state socialism and the second economy, Pérez-López (1995) has applied the concept of the "second economy" directly to the Cuban case during the "special period." Like Grossman (1977) and Los (1987, 1990), Pérez-López makes the important observation that the critical criterion in his definition of Cuba's second economy is "control" rather than "legality."

Thus, the second economy concept is appropriate for Cuba because it includes "all those economic activities which are inconsistent with the dominant ideology that shapes the official ('first') economy" (1995: 14), not simply those which have been officially outlawed. Furthermore, Pérez-López contends that the second economy concept fits the Cuban context better than that of mere "informality" since in Cuba the rise in individual entrepreneurial activity takes place in a political context where societal gain is preferred over private gain. It is this particular understanding of the second economy that I employ here.

Those few researchers who have published on Cuba's second economy, and the even fewer whose work is based on original research carried out on the island, raise many provocative questions that indicate why further study of Cuba's second economy is important. First, because it operates outside the realm of government control, Cuba's second economy may pose a long-term threat to the state monopoly of central economic planning on the island—even while it helps hold a flawed system together in the short-term. Second, while the state's response to the second economy has alternated over time between repression and benign neglect, the Cuban government initially attempted to incorporate parts of it by strengthening its articulation with the official economy and instituting licensing requirements. Third, while now undergoing a major retrenchment,² Cuba's past experiments with a limited number of market-oriented reforms do mirror the stages of other socialist countries.

However, even after fifteen years of experimentation and survival, it is still unclear whether the transformation of Cuba's socialist economy (and the role of microenterprise and the second economy therein) will most closely resemble that of the Soviet Union,

2. Though the jury is still out on the ultimate outcome of Cuba's reform process initiated in 1990, major recent retrenchment and recentralization on the island without much visible political or popular fallout from either elites or entrepreneurs indicate that the Cuban may yet defy the path-dependent logic of the reform processes in other socialist countries. The discovery of oil deposits, political and material support from Venezuela, and credits from China also strengthen the government's ability to limit or reverse previous economic reforms without provoking negative consequences. However, rising tensions among the population since 2001, exacerbated by the slow pace of economic recovery and growing frustration with persistent material scarcity and continued blackouts, may lead to demands for more and deeper reforms or boil over and fuel the tiny internal political opposition.

China, Hungary, or its Caribbean and Latin American neighbors. It is also unclear, given Cuba's unique history, culture, leadership, and relationship to the

United States, whether it will remain an anomaly and develop its own hybrid economic transformation.

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