

The Mystery of Capital

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Why does capitalism thrive in the west but not in many developing countries? Global capitalism has been tried before in various parts of the world. In Latin America, for example, reforms have been tried at least four times since independence from Spain in the 1820s. Each time, after the initial euphoria, Latin America swung back from capitalist and market economy policies.

Westerners rationalise these setbacks by blaming people in the poor countries for their lack of entrepreneurial spirit or market orientation. Other popular explanations are lack of Protestant ethic, the legacy of colonialism and low IQ.

According to De Soto, the major stumbling block that keeps the rest of the world from benefiting from capitalism is its inability to produce capital. Capital is the force that raises the productivity of labour and creates the wealth of nations. It is the lifeblood of the capitalist system, the foundation of progress, and the one thing that the poor countries of the world cannot seem to produce enough for themselves.

Introduction

De Soto argues in this seminal book that the poor cannot produce capital not because they do not possess assets. But they hold these assets in defective forms: houses built on land whose ownership rights are not adequately recorded, or unincorporated businesses with undefined liability. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside narrow local circles where people know and trust each other and cannot be used as collateral for a loan.

In the West, by contrast, land, building and equipment are represented in a property document that connects all these assets to the rest of the economy. Thanks to this representational process, land can be used as collateral for raising loans. Third World and former communist nations do not have this representational process. The enterprises of the poor are very much like corporations that cannot issue shares or bonds to obtain new investments and finance.

In poor countries, although people frequently break the law, their entrepreneurial ingenuity has created wealth on a vast scale. These assets far exceed the holdings of the government, the local stock exchanges and foreign direct investment. According to the author, the total value of the “illegal” real estate held by the poor of the Third World and former communist nations is at least \$9.3 trillion, about twice as much as the total circulating US money supply. But in the absence of a suitable representational process, the value of these assets remains locked up.

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Bringing capital to life requires us to go beyond looking at our assets as they are to thinking actively about what they could be. It requires a process for fixing an asset’s economic potential into a form that may be used to generate additional value.

Assets need a formal property system to produce significant surplus value. Without such a system, these assets are like water at a height – an untapped stock of potential energy.

Capital is born by representing in writing – in a title, a security, a contract and other such records – the most economically and socially useful qualities about the asset. Property is not the house itself but an economic concept about the house, embodied in a legal representation. A formal property representation is something separate from the asset itself. Capitalism has triumphed in the West because most of the assets in Western nations have been integrated into one representational system.

The integration of all property systems under one formal property law shifted the legitimacy of the rights of owners from the politicized context of local communities to the impersonal context of law. Releasing owners from restrictive local arrangements and bringing them into a more integrated legal system facilitated their accountability. A large part of the potential value of legal property is derived from the possibility of forfeiture. Consequently, a great deal of its power comes from the accountability it creates.

Unlike developed countries, the developing and former communist nations have hundreds of representational systems, managed by all sorts of organizations, some legal, others extralegal. Consequently, what people in those countries can do with their property is limited to the imagination of the owners and their acquaintances. In Western countries, what owners can do with their assets benefits from the collective imagination of a larger network of people.

A formal property system makes assets more tradable and unlocks value. Unlike physical assets, representations can be easily combined, divided, mobilized and used to stimulate business deals. By uncoupling the economic features of an asset from its rigid, physical state, a representation makes the asset ‘fungible’ – able to be fashioned to suit a wide range of transactions.

Standard property descriptions in the West facilitate the combination of assets. Formal property rules require assets to be described and characterized in a way that not only outlines their singularity but points out their similarity to other assets, thus making potential combinations more obvious.

Representations also enable the division of assets without touching them. Citizens of advanced nations are thus able to split most of their assets into shares, each of which can be owned by different persons, with different rights, to carry out different functions. Thanks to formal property, a single factory can be held by countless investors, who can divest themselves of their property without affecting the integrity of the physical asset. Formal property representations can also serve as movable stand-ins for physical assets, enabling owners and entrepreneurs to stimulate hypothetical situations in order to explore other profitable uses of their assets.

By making assets fungible – capable of being divided, combined or mobilized to suit any transaction – by attaching owners to assets, assets to addresses, and ownership to enforcement,

and by making information on the history of assets and owners easily available, the western property system has radically improved the flow of communications about assets and their potential. Western legal property also provides businesses with information about assets and their owners, verifiable addresses and objective records of property value, all of which lead to credit records. This information and the existence of integrated law make risk more manageable by spreading it through insurance-type devices, as well as by pooling property to secure debts.

The legal property system of an advanced nation is the centre of a complex web of connections that equip ordinary citizens to form ties with both the government and the private sector, and so on to obtain additional goods and services. The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. A well-integrated legal property system makes asset transactions more efficient by representing them in a way that we understand easily. Assets can be used to increase production and facilitate the division of labour.

Need for political action

Urbanisation has transformed once small cities like Jakarta, Mexico City, Sao Paolo, Nairobi, Bombay, Shanghai and Manila into mega-cities. Migrants into these cities have invented extralegal substitutes for established law. When the poor have already taken control of vast quantities of real estate and productive economic units, and the written law is in conflict with the laws citizens live by, discontent, corruption, poverty and violence will result. The extra-legality plaguing these cities closely resembles what the advanced nations of the West went through during their own industrial revolution. Tackling this problem calls for determined political action.

If we look at the west, a couple of hundred years back, the extralegals' numbers, persistence and success began to undermine the very foundations of the mercantilist order. Whatever success they had, it was won in spite of the state, and they were bound to view the authorities as their enemies. In those countries where the state outlawed and prosecuted extralegal entrepreneurs instead of adjusting the system to absorb their enterprise, not only was economic progress delayed but unrest increased, spilling into violence. The best known manifestations were the French and Russian revolutions. Those countries that adapted quickly, however, made a relatively peaceful transition to a market economy. Some countries realized that people employed in the extralegal sector were socially, politically and economically preferable to a growing number of unemployed migrants. By easing access to formal property, reducing the obstacles engendered by obsolete regulations and allowing existing local arrangements to influence lawmaking, European politicians eliminated the contradictions in their legal and economic systems and allowed their nations to carry the Industrial Revolution to new heights. In America too, politicians played a crucial role in tackling the problem of extralegal arrangements, as explained in the next section.

Lessons from the US

The transition to integrated legal property systems in the west was essentially about adapting the law to the social and economic needs of the majority of the population. Gradually, Western nations acknowledged that social contracts born outside the official law were a legitimate source of law and found ways of absorbing these contracts. No country illustrates this better than the US.

The migrants realized that to live peacefully, they had to establish some sort of order, even if it had to be outside the official law. Squatters began inventing their own species of extralegal property titles. 'Tomahawk rights' were secured by deadening a few trees near the head of a spring and marking the bark of one or more trees with the initials of the person who made the improvement. In the 1660s, squatters in Maryland developed the custom of marking trees on the lands they wanted before they were surveyed with the permission of the colony's surveyor-general. By the end of the American Revolution, the practice of marking trees for possessory right to lands had become widely accepted.

'Cabin rights' and 'corn rights' meant staking out land by building a log cabin or raising a crop of corn respectively. Significantly, these extralegal rights were bought, sold and transferred – just like official titles. These extralegal property rights helped avoid quarrels, were widely accepted in America's frontier communities, and became the source of legal title years later.

Under English law, people who mistakenly occupied another person's land and made improvements, could not recover the value of what they had done. In the colonies, however, given the lack of effective government and reliable records and surveys, authorities had to accept that improvements made on land, taxes paid and local arrangements among neighbours were also acceptable sources of property rights. In 1642, the colony of Virginia allowed a wrongful possessor to recover the value of any improvements from the true owner. Moreover, if the rightful owner was unwilling to reimburse the squatter for these improvements, the squatter could purchase the land at a price set by a local jury. This statute was soon copied by other colonies. This legal innovation of allowing settlers to buy the land they had improved before it was offered for public sale was known as 'pre-emption'. This principle became the key to the integration of extralegal property arrangements in American law over the next 200 years.

All this did not happen in one stroke. For some time, Congress was out of touch with reality: it had no conception of the sheer dimension of the pressure from squatters, nor did it have the means to impose its mandates. At the beginning of the nineteenth century, the property system of the United States was in a state of disarray. Existing property law and antagonistic legislators only exacerbated the crisis facing the nation's migrants.

Migrants did not have formal title to their property and usually ended up having to negotiate for the title with not one but two owners. Even after they had purchased the land and made their improvements, they were likely to be faced with ejectment proceedings brought by others with prior rights to their tracts.

Between 1785 and 1890, the US Congress passed over 500 different laws to reform the property system. The complicated procedures associated with these laws, however, often hampered this goal. To confuse matters further, individual states developed their own rules of property and land distribution that largely benefited and protected only their elite. As a result, attempts to reform the property system only served to heighten the difficulties while making migrants extremely wary about losing what semblance of title they might have possessed.

The settlers who wanted to secure their property rights, fashioned their own 'laws', especially those pertaining to property, fusing English law and the home grown American legal traditions with their common sense. Gradually, American politicians became champions of extralegal rights. The expansion of occupancy laws – recognizing a right to land based on improvements made on it – throughout the United States during the first sixty years of the nineteenth century, reflected this approach. Politicians began viewing squatters through a different prism, as 'noble pioneers' helping to develop the country. Of course, they were also potential voters. In 1828 the Public Lands Committee admitted that the American squatter had performed a valuable public service for which he deserved compensation. The squatter 'had brought into competition lands which otherwise would have commanded no price and for which there would have been no bidders, unless for his improvements.'

Meanwhile squatters did everything they could to secure the land they occupied. Some even paid twice for the same parcel, while others paid lawyers enormous fees to help them make their land legal. Many did not have the means to cover the costs of the official legal system, so they established their own extralegal arrangements. For all practical purposes, they took the law into their own hands – and forced the legal establishment to follow their lead. It took the politicians some time before they realized that extralegal social contracts for property had taken shape and that they constituted an essential part of the nation's property rights system.

In 1862, when Congress passed the celebrated 'Homestead Act' that gave 160 free acres to any settler willing to live on the land for five years and develop it, it was only sanctioning what settlers had already done themselves. In spite of the legendary fame of the Homestead Act, most settlements took place before it was enacted.

The 1866 legislation not only acknowledged the legitimacy of social contracts born outside the official law, but also incorporated principles and rights that had been won by settlers in pre-emption and settlement claims. The law also extended rights to any person or association that had expended \$1,000 in labour and improvements on a claim, surveyed or un-surveyed. This was an explicit recognition that value added to assets was something the law needed to encourage and protect.

In passing laws to integrate the extralegal population, American politicians essentially endorsed the principle that legal institutions had to respond to social needs. The American legal system built on the experience of grassroots Americans and the extralegal arrangements they created, while rejecting those English common law doctrines that had little relevance to problems unique to the United States.

The American experience shows that for the legal system to gain legitimacy, there is a three fold task; we must find the real social contracts on property, integrate them into the official law and craft a political strategy that makes reform possible.

The Mystery of Legal Failure

Governments in developing countries have tried for several years to open up their property systems to the poor. They have failed because they usually operate under five basic misconceptions:

- People who take cover in the extralegal or underground sectors do so to avoid paying taxes;
- Real estate assets are not held legally because they have not been properly surveyed, mapped and recorded;
- Enacting mandatory law on property is sufficient, and governments can ignore the costs of compliance with that law;
- Existing extra legal arrangements or 'social contracts' can be ignored;
- People's conventions on how they can hold their assets, both legal and extralegal, can be changed without high-level political leadership.

People do not operate in the extralegal sector to evade taxes. Operating in the underground economy is hardly cost-free. Extralegal businesses are severely handicapped by the lack of good property law. They also have to continually hide their operations from the authorities. They cannot secure low-interest formal credit because they do not even have legal addresses. They cannot reduce risks by declaring limited liability or obtaining insurance coverage. The only 'insurance' available to them is that provided by their neighbours and the protection that local bullies or mafias are willing to sell them. Moreover, because extra legal entrepreneurs live in constant fear of government detection and extortion from corrupt officials, they are forced to operate fragmented production facilities across many locations, thereby forgoing economies of scale. With one eye always on the lookout for the police, underground entrepreneurs cannot openly advertise to build up their clientele or make less costly bulk deliveries to customers. In short, in most countries, being free from the costs and hassles of operating in the extralegal sector more than compensates for paying taxes.

What keeps most people in developing and former communist nations from using modern formal property to create capital is a bad legal and administrative system. A few elites hold property using codified law borrowed from the West. For others, property is used and protected by various extralegal arrangements firmly rooted in informal consensus. These local social contracts represent a collective understanding of how things are owned and how owners relate to each other. Creating one national social contract on property involves understanding the psychological and social processes that are contained in these local social contracts and then using the tools that professional law provides to weave them into one formal national social contract. This is what Western nations achieved not so long ago.

Another prime misconception is that real estate assets cannot be legally registered unless they have been surveyed, mapped and recorded with state-of-the-art geomatic information technology. Western countries managed to record all their real estates assets decades before computers and geographical information systems were invented.

The essence of property does not lie in its physical attributes. Property is for all purposes a consensus among people as to how assets should be held, used and exchanged. The challenge today in most non-Western countries is not to put all the nation's land and building into the same map but to integrate the formal legal conventions with the extralegal ones. Surveying and mapping or computerizing will not accomplish this.

As mentioned earlier, politicians not the lawyers should lead the integration processes. There are various reasons for this. Law is generally concerned with protecting property rights, but the real task in developing countries is not so much to perfect existing rights as to give everyone a right to property rights. Bestowing such meta-rights, is a political job. Creating an integrated system is not about drafting laws and regulations that look good on paper, but rather about designing norms that are rooted in people's beliefs and are thus more likely to be obeyed and enforced. Being in touch with people is a politician's task. Prodding underground economies to become legal is a major political sales job. Governments must convince poorer citizens, some of the mafias who protect them, and influential leftists, who in many countries are close to the grassroots. Lawyers can hardly be entrusted with such responsibilities.

Property arrangements work best when people have formed a consensus about the ownership of assets and the rules that govern their use and exchange. Any attempt to create a unified property system must take into account the collective contracts that underpin existing property arrangements. The transition from extralegal relations to unified formal property in advanced nations was not built on thin air. The systematization of the laws that underpin modern property rights structures was possible only because authorities allowed pre-existing extralegal relationships among groups on the ground sometimes to supersede official laws.

De Soto mentions that most extra legal social contracts about property are basically similar to national social contracts in Western nations. Both tend to contain some explicit or tacit rules about who has rights over what and the limits to those rights and to transactions. They also include provisions to record ownership of assets, procedures to enforce property rights and claims, symbols to determine where the boundaries are, norms to govern transactions, criteria for deciding what requires authorized action and what can be carried out without authorization, guidelines to determine which representations are valid, devices to encourage people to honour contracts and respect the law, and criteria to determine the degree of anonymity authority for each transaction. As mentioned earlier, the problem with extralegal social contracts is that their property representations are not sufficiently codified and fungible to be acceptable outside their local context.

A strategy to capitalize the poor has to integrate two apparently contradictory property systems within the same body of law. If it is to succeed, leaders have to do at least three specific things: take the perspective of the poor, co-opt the elite and deal with the legal and technical bureaucracies that protect the status quo.

With the poor on their side, leaders intent on reform have already won at least half the battle. Any opposition will be hard pressed to take on the head of state and most of the people. When

poor people have confidence that their land and business are legally theirs, their respect for other people's property increases. Formal, up-to-date property records will also provide the police with the information necessary for maintaining law and order without resorting to unnecessary arrests.

Owning formal property also tends to discourage unruly behaviour. Without an effective legal system, society in effect invites the gangsters and terrorists to do the job. Property also provides a legal alternative to drug trafficking. As long as the farmers remain illegal landowners, short-term cash crops, like coca and opium poppies, remain their only alternative. For small farmers in some areas of the developing world, money advanced by drug traffickers is practically the only credit available.

Once reformers have the poor and some of the elite on their side, it will be time to take on the public and private bureaucracy who administer and maintain the status quo-principally, the lawyers and the technicians.

Although entrepreneurs and ordinary people are the builders of capital and capitalism, it is lawyers who fix property concepts in tangible representative form and define those concepts in statutes. Any government eager to pursue an integrated property system must therefore have a strategy for dealing with the legal profession. The key is to choose courageous, reform-minded lawyers who exist in every nation.

Property creation programmes will not take off as long as governments think that once they have photographed, surveyed, measured and computerized the inventories of their physical assets they have all the information required to issue property titles. Photographs and inventories only inform authorities of the physical state of the assets; they say nothing about who really owns those assets or how people have organized the rights that govern them. Photographs and computer inventories do not convey the local rules that enforce these rights or the network of relationships that sustain them.

People will join the formal system when its economic benefits are obvious to them and when they are certain their rights will continue to be protected. As long as these rights are protected by an extralegal social contract, people will see no reason to notify authorities of any changes in the disposition of their assets. Only when formal law replaces extralegal arrangements as the source of protection for property, will people accept its legitimacy and be interested in providing authorities with the information required to keep their maps and records current. The place where the social contract is located determines where the records and maps can be kept current.

At least half the job of property reform in a short time is about communication. Leaders need to describe how popular capitalism will affect many different interest groups, show them the benefits they will derive from it and persuade them that it is a win-win exercise for all segments of society. For the extralegal sector, these leaders must address their pent-up entrepreneurial energy and demonstrate the advantages of integrating a new formal law. For the legal sector, they must explain that the proposed reforms will not hurt legitimate and enforceable rights and that there will be aggregate gains for all interest groups.

Conclusion

The lifeblood of capitalism is capital. Only capital provides the means to support specialization and the production and exchange of assets, vital for a vibrant market. Capital is the source of increasing productivity. Poor countries cannot inject life into their assets and make them generate capital because the law keeps them out of the formal property system. They are tied to myriad disconnected informal agreements. Without the common standards that legal property brings, they lack the language necessary for their assets to talk to each other.

Formal property is more than a system for titling, recording and mapping assets – it is an instrument of thought, representing assets in such a way that people’s minds can work on them to generate surplus value. That is why formal property must be universally accessible: to bring everyone into one social contract where they can cooperate to raise society’s productivity.

A good legal property system obtains and organizes knowledge about recorded assets in forms that can be controlled. It collects, integrates and coordinates not only data on assets and their potential, but our thoughts about them. In brief, capital results from the ability to use property systems to represent their resources in a virtual context. Only then can minds meet to identify and realize the meaning of assets for mankind.

A good property system puts assets into a form that lets us record their similarities, differences and connecting points with other assets. It fixes them in representations that the system can track across time and space. In addition it allows assets to become fungible so that they can be easily combined, divided and mobilized to unlock more value.

By representing economic aspects of the things we own and assembling them into categories that our minds can quickly grasp, property documents reduce the costs of dealing with assets and increase their value commensurately.

Throughout history, people have confused the efficiency of the representational tools they have inherited to create surplus value with the inherent values of their culture. Many Westerners believe that what underpins their successful capitalism is the protestant work ethic they have inherited, or the values underpinning their religion. Therefore, a great part of the research agenda remains mired in a mass of unexamined and largely untestable assumptions labeled ‘culture’. Much behaviour that is today attributed to cultural heritage is not the inevitable result of people’s ethnic or idiosyncratic traits but of their national acceptance of the relative costs and benefits of entering the legal property system.

Capitalism is out of touch with those who should be its largest constituency. It makes no sense continuing to call for open economies without accepting that the economic reforms under way open the doors only for small and globalized elites and leave out most of humanity. We need to challenge conventions and create a new property system that will be inclusive and bring the poor and those living in the extralegal sector into the mainstream.