

## **Hernando de Soto on property**

### **Listening to the barking dogs: property law against poverty in the non-West<sup>1</sup>**

#### **The problem**

Imagine a country where nobody can identify who owns what, people cannot be made to pay their debts, resources cannot conveniently be turned into money, ownership cannot be divided through documents, descriptions of assets are not standardized and can not be easily compared, and the rules that govern property vary from neighbourhood to neighbourhood or even from street to street. You have just put yourself into the life of a developing country or former communist nation; more precisely, you have imagined life for 80 per cent of its population, which is marked off as sharply from its Westernized elite as black and white South Africans were once separated by apartheid.

Over the last 10 years, with varying degrees of enthusiasm, Third World and former Soviet Union nations—where 5 billion of the world's 6 billion people live—carried out the macroeconomic policies the West recommended: they balanced their budgets, cut subsidies, welcomed foreign investment, and dropped their tariff barriers. Yet from Argentina to Russia, capitalist reformers are now intellectually on the defensive, increasingly derided as apologists for the miseries and injustices that still plague the poor.

As a result, we are now beginning to realize that you cannot carry out macroeconomic reforms on sand. Capitalism requires the bedrock of the rule of law, beginning with that of property. This is because the property system is much more than ownership: it is in fact the hidden architecture that organizes the market economy in every Western nation. What the property system accomplishes is so central to capitalism that developed nations have come to take its success for granted; indeed even most property experts are unsure about the connections between property systems and the creation of capital. Yet these connections exist. Without them, buildings and land cannot be used to guarantee credit or contracts. Ownership of businesses cannot be divided and represented in shares that investors can buy. In fact, without property law, capital itself—the

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instrument that allows people to leverage their assets and their transactions—is impossible to create: the instruments that store and transfer value, such as shares of corporate stock, patent rights, promissory notes, bills of exchange, bonds, etc, are all determined by the architecture of legal relationships with which a property system is built. And the problem is that 80 percent of the population of developing and former communist nations do not have legal property rights over their assets, whether it be homes, businesses or intellectual creations.

When property law works, the capital value of assets rise in developing nations. In 1990, for example, the Compañía Peruana de Teléfonos (CPT) was valued on the Lima stock exchange at \$53 million. The government, however, could not sell the CPT to foreign investors because they found that the company's property title over its assets, and Peruvian property law itself, were unclear. Consequently, the Peruvians put together a hotshot legal team to create a legal title that would meet the standardized property norms required by the global economy. Documents were rewritten to secure the interests of other parties and create confidence that would allow for credit and investment. The legal team also created enforceable rules for settling property disputes that bypassed the dilatory and corruption prone Peruvian courts. Three years later, CPT entered the world of liquid capital and was sold for \$2 billion—37 times its previous market valuation. That's what a good property system can do.

The enterprises of the poor are very much like the Peruvian Telephone Company before it had good title and could issue shares or bonds to obtain new investment and finance. No less than 80 per cent of the people in Third World and former Soviet nations have good property representations. As a result, most of them are undercapitalized, in the same way that a firm is undercapitalized when it issues fewer securities than its income and assets would justify. Without property records and representations, their assets remain financially and commercially invisible: they are dead capital.

In the West, by contrast, every parcel of land, every building, every piece of equipment is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. Thanks to this representational process, assets can lead an invisible, parallel life alongside their material existence. They can be used as collateral for credit. The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities. By this process, the West injects life into assets and makes them generate capital.

Why have these reforms not been made? One reason is that conventional macroeconomic reform programs have ignored the poor, assuming they

have no wealth to build on. Big mistake. My research team and I have recently completed several studies of the underground economy throughout the Third World and they prove that the poor are, in fact, not so poor. In Egypt, the poor's assets in real estate are worth an estimated \$241 billion—55 times the sum of all foreign investment in the country in the last 150 years, including the Suez Canal and the Aswan Dam. In Mexico, the estimate is \$ 315 billion—7 times the worth of the national oil monopoly.

The problem is that most people outside the West hold their resources in defective forms: houses built on land whose ownership rights are not adequately recorded, industries located where financiers and investors cannot see them. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other and cannot be used as collateral for a loan.

### **Legal property is 'mind-friendly'**

How is it that a piece of paper representing ownership can create value? Not everything that is real and useful is tangible and visible. Time, for example, is real, but it can only be efficiently managed when it is represented by a clock or a calendar. Throughout history, human beings have invented representational systems—writing, musical notation, double entry bookkeeping—to grasp with the mind what human hands could never touch. In the same way, the great practitioners of capitalism, were able to reveal and extract capital where others saw only junk by devising new ways to represent, through property systems, the invisible potential that is locked up in the assets we accumulate. The genius of the West was to have created such a system.

What distinguishes a good legal property system is that it is 'mind friendly'. The revolutionary contribution of an integrated property system is that it solves a basic problem of cognition. Our five senses are not sufficient for us to process the complex reality of an expanded market, much less a globalised one. We need to have the economic facts about ourselves and our resources boiled down to essentials that our minds can easily grasp. A good property system does that—it puts assets into a form that lets us distinguish their similarities, differences, and connecting points with other assets. It fixes them in representations that the system tracks as they travel through time and space. In addition, it allows assets to become fungible so that we can easily combine, divide, and mobilize them to produce higher-valued mixtures. This capacity of property to represent aspects of assets in forms that allow us to recombine them so as to make them even more useful is the mainspring of economic growth, since growth is all about obtaining high-valued outputs from low-valued inputs.

I do not believe that the absence of this process in the poorer regions of the world—where five-sixths of humanity lives—is the consequence of some Western monopolistic conspiracy. It is rather that Westerners take this mechanism so completely for granted that they have lost all awareness of its existence. However, it is this system that has given the West an important tool for development. The moment Westerners were able to focus on the title of a house and not just the house itself, they achieved a huge advantage over the rest of humanity. With titles, shares and property laws, people could suddenly go beyond looking at their assets as they are (houses used only for shelter) to thinking about what they could be (security for credit to start or expand a business).

In the West, this formal property system begins to process assets into capital by describing and organizing the most economically and socially useful aspects about assets, preserving this information in a recording system—as insertions in a written ledger or a blip on a computer disk—and then embodying them in a title. A set of detailed and precise legal rules governs this entire process. Formal property records and titles thus represent our shared concept of what is economically meaningful about any asset. They capture and organize all the relevant information required to conceptualize the potential value of an asset and so allow us to control it. Property is the realm where we identify and explore assets, combine them, and link them to other assets. The formal property system is the place where capital is born.

### **Injecting life into dead capital**

Any asset whose economic and social aspects are not fixed in a formal property system is extremely hard to move in the market. How can the huge amounts of assets changing hands in a modern market economy be controlled, if not through a formal property process? Without such a system, any trade of an asset, say a piece of real estate, requires an enormous effort just to determine the basics of the transaction: does the seller own the real estate and have the right to transfer it? Can he pledge it? Will the new owner be accepted as such by those who enforce property rights? What are the effective means to exclude other claimants? In developing and former communist nations, such questions are difficult to answer. For most goods, there is no place where the answers are reliably fixed. That is why the sale or lease of a house may involve lengthy and cumbersome procedures of approval involving all the neighbours. This is often the only way to verify that the owner actually owns the house and there are no other claims on it. It is also why the exchange of most assets outside the West is restricted to local circles of trading partners.

As we are now discovering, these countries' principal problem is not the lack of entrepreneurship: according to the studies done by the Institute for Liberty and Democracy in Peru, the poor of the developing world have accumulated nearly 10 trillion dollars of real estate during the past forty years. What the poor lack is easy access to the property mechanisms that

could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market.

Centuries ago, scholars speculated that we use the word 'capital' (from the Latin for 'head') because the head is where we hold the tools with which we create capital. This suggests that the reason why capital has always been shrouded in mystery is because, like energy, it can be discovered and managed only with the mind. The only way to touch capital is if the property system can record its economic aspects on paper and anchor them to a specific location and owner. Property, then, is not mere paper but a mediating device that captures and stores most of the stuff required to make a market economy run.

(...) 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.

How can modern property systems be established in non-Western countries? As things stand, most arrangements that govern the holding and transaction of assets in non-Western nations are established outside the formal legal system. Extralegal property arrangements are dispersed among dozens, sometimes hundreds, of communities; rights and other information are known only to insiders or neighbours. To modernize any of these countries, all the separate, loose extralegal property arrangements characteristic of most Third World and former communist nations must be woven into a single system from which general principles of law can be drawn. In short, the many social contracts 'out there' must be integrated into one, all-encompassing social contract.

How can this be accomplished? How can governments find out what the extralegal property arrangements are? That was precisely the question put to me by five members of the Indonesian cabinet. I was in Indonesia and they took that opportunity to invite me to talk about how they could find out who owns what among the 90 percent of Indonesians who live in the extralegal sector. Fearing that I would lose my audience if I went into a drawn-out technical explanation on how to structure a bridge between the extralegal and legal sectors, I came up with another way, an Indonesian way, to answer their question. During my book tour, I had taken a few days off to visit Bali, one of the most beautiful places on earth. As I strolled through rice fields, I had no idea where the property boundaries were. But the dogs knew. Every time I crossed from one farm to another, a different dog barked. Those Indonesian dogs may have been ignorant of formal law, but they were positive about which assets their masters controlled.

I told the ministers that Indonesian dogs had the basic information they needed to set up a formal property system. By travelling their city streets and countryside and listening to the barking dogs, they could gradually work upward, through the vine of extralegal representations dispersed throughout their country, until they made contact with the ruling social contract. "Ah", responded one of the ministers, "*jukum adat*" (the people's law)!

Discovering "the people's law" is how Western nations built their formal property systems. Any government that is serious about reengineering the ruling informal agreements into one national formal property social contract needs to listen to its barking dogs. To integrate all forms of property into a unified system, governments must find out how and why the local conventions work and how strong they actually are. This may sound oxymoronic or even subversive to Western readers who have come to believe there is only one law to obey. But my experience visiting and working in dozens of developing nations has made it clear to me that legal and extralegal laws coexist in all of them.

Over the last 15 years, what we have learned to do at the Institute for Liberty and Democracy—not only in South America, but also in the Middle East, Asia, the Caribbean and North America—is to identify the written or unwritten extralegal norms and their representations, disembody them from their surroundings and, on the basis of the common denominators we find, bring them together in one professionally crafted code acceptable to all. This process of moving norms and representations from informal and local contexts towards a formal and universal context we call the 'representational ascent'.

In each country we work in, once we have identified the main traits of the extralegal norms governing extralegal systems, we compare them to the official law which is essentially an 'elite law' because it is obviously rejected or not applicable to most of the nation. Then, through a process of consultations with both the extralegal and legal leaders, we blend the better parts of extralegal local laws with the acceptable parts of elite law so as to produce a unified formal code applicable throughout the land.

The reason we take extralegal law seriously is that it is stable and meaningful for those who work outside the legal system. Nowhere we have visited have we encountered people working extralegally oppose integrating into the legal sector, provided that the law which is proposed to them is grounded in their customs and beliefs, explained to them in their vocabulary, and does not involve high transaction costs they cannot afford.

We learned how to discover extralegal arrangements and how to integrate them into one legal system by studying how, over centuries, Western nations and Japan made the transition from dispersed, informal arrangements to an integrated legal property system on the basis of which

the rule of law was established. This historical knowledge accounts for some of the inputs we obtained to make a transition process. Most of the knowledge, however, we obtained through our own empirical research in developing countries. In the field, we brailled our way through extralegal worlds and eventually learned how to get in touch with the social contracts that underlay property rights. Discovering these arrangements is nothing like searching for proofs of ownership in a formal legal system. The extralegal sector does not have, among other things, the centralized recording and tracking bureaucracy that is at the centre of formal society. What people in the extralegal sector do have are strong, clear, and detailed understandings among themselves on the rules that establish who owns what. Even the dogs obey them.

Consequently, the only way to find the extralegal social contract on property in a particular area is by contacting those who live and work by it. Obtaining synchronic information takes fieldwork: going directly to those areas where property is not officially recorded (or poorly recorded) and getting in touch with local legal and extralegal authorities to find out what the property arrangements are. This is not as hard as it sounds. Although oral traditions may predominate in the rural backwoods of some countries, most people in the extralegal urban sector in developing countries have found ways to represent their property in written form according to rules that they respect and that government, at some level, is forced to accept.

In Haiti, for instance, no one believed we would find documents fixing representations of property rights. Haiti is one of the world's poorest countries; 55 per cent of the population is illiterate. Nevertheless, after an intensive survey of Haiti's urban areas, we did not find a single extralegal plot of land, shack, or building whose owner did not have at least one document to defend his right—even his 'squatting rights'. Everywhere we have been in the world, most poor people living on the margins of the law have some locally crafted or adapted physical artefact to represent and substantiate their claim to property. And it is on the basis of these extralegal representations, as well as records and interviews, that we are everywhere able to build a concept of the social contract undergirding property.

Once we get our hands on extralegal representations, we have found the Ariadne's thread leading to the social contract on which one can build self-enforcing codes. Representations are the result of a specific group of people having reached a respected consensus as to who owns what property and what each owner may do with it. Reading representations themselves and extracting meaning from them does not require a degree in archaeology. They contain no mysterious codes to be deciphered. People with very straightforward, business-like intentions have written these documents to make absolutely clear to all concerned what rights they claim to have over the specific assets they control. They want to communicate the legitimacy of their rights and are prepared to provide as

much supporting evidence as possible. Their representations have nothing to hide; they have been designed to be recognizable for what they are. This is not always so obvious because, regrettably, when dealing with the poor we tend to confuse the lack of a centralized record-keeping facility with ignorance.

When we obtain documentary evidence of representations, we can then 'deconstruct' them to identify the principles and rules that constitute the social contract that sustains them. Once we have done that, we will have all the major relevant pieces of extralegal law. The next task is to codify them—organize them in temporary formal statutes so that they can be examined and compared with existing formal law. Encoding loose systems is also not a problem. In fact, it is not much different from government procedures to make legal texts uniform within countries (such as the US Unified Commercial Code) or between countries at an international level (such as the many integrated mandatory codes produced by the European Union or the World Trade Organization). By comparing the extralegal to the legal codes, government leaders can see how both have to be adjusted to fit each other and then build a regulatory framework for property—a common bedrock of law for all citizens—that is genuinely legitimate and self-enforceable because it reflects both legal and extralegal reality. That was basically how Western law was built: by gradually discarding what was not useful and enforceable and absorbing what worked.

### **Giving governments the tools for reform**

At the end of our work, we present the host government with a step-by-step program for reforming existing institutions that will allow to integrate under one law all the economic stock and activities in the country. This will require replacing bad law and administrative practices with statutes and procedures that make assets fungible by attaching owners to assets, assets to addresses, ownership to legal accountability, commitments to enforcement, and by making all information and the history on assets and owners easily accessible. The goal is to create a formal property system that converts a previously anonymous and dispersed mass of owners into an interconnected system of individually identifiable and accountable business interlocutors that are able to create capital.

This includes boiling down the reform program to a comprehensive mission statement along with publicity devices that allow politicians to motivate their constituencies toward reform. Such a communications program tailors the message to each constituency: the poor must be convinced that they will prosper more within a legal economy than outside it; private businessmen and banks must see that integrating the extralegal economy means larger markets with goods and services; politicians must be convinced that the government's tax base will be broadened so as to increase its revenues and reduce its reliance on foreign aid; and the whole

nation must see that inclusion will decrease macroeconomic deficiencies and reduce the expansion of black markets, criminality, mafias and drugs.  
(...)