

Hernando de Soto's Mysteries

Efraín Gonzales de Olarte

The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else, by Hernando de Soto. New York, NY: Basic Books, 2000. 276 pp. \$27.50.

Fifteen years after the publication of *the other path*, the book that would make Hernando de Soto famous, he has delivered *The mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. The basic argument remains the same, namely, that informality constitutes an obstacle for the developed.

The book is based on the thesis that an array of unused physical assets in developing countries, “dead capital”, would lead to development if they were used. The main hurdle that prevents dead capital from becoming “live capital” is a sociopolitical system that combines the state's political and bureaucratic sluggishness, the lack of information, and the absence of a legal property system. This diagnosis leads De Soto to formulate a true vademecum of recipes for political and institutional neoliberal reforms.

A must-read for liberal and neoliberal reformists, this book attempts to solve problems raised in *the Other Path* with new arguments and ideas for attaining capitalist development. It is also an easy read except for some complex graphs, presented for specialists or policy-makers rather than for the average reader.

Hernando de Soto y Polar is a Peruvian economist trained in Switzerland who has studied the informal sector for the last two decades, first in Peru and then in Haiti, the Philippines, and lately in Egypt. His first book, *The Other Path*, was a great publishing success and influenced neoliberal thought to the point that it became President Ronald Reagan's bed-side read. De Soto was an adviser to such ideologically distinct Peruvian presidents as left-of-center Alan García and neoliberal Alberto Fujimori, and currently advises Mexican President Vicente Fox. His proposals for granting formal titles to holders of informal real estate have been carried out in Peru and elsewhere with some success. De Soto promotes neoliberal ideas at a moment when neoliberalism no longer seems to be the miraculous medicine for development it was once held in some circles.

Informality and its Context

The main contribution of De Soto's new book is to place informality in the broader context of the system that creates and recreates it, enabling him to discover the mysterious factor that hinders capitalist development. What is under discussion in academic and political circles is whether

informality is truly the main obstacle to development, one factor among many, or an inevitable phase in late capitalist development.

Although he recognizes in this book that there are other more systemic factors that affect development, he does not incorporate crucial elements such as human capital into his analysis. His argument limits itself to the potentiality of dead physical capital. Thus, the book is about how to build a bridge from the land of dead capital (informality) to the land of live capital (formality). Once this link is established, any country will start down the path to development almost automatically. Yet the only live capital is the human being, or human capital as it is called nowadays, which, ultimately, is the only one able to accrue, modify, or destroy the value of any “dead capital”, including physical capital. The formalization or incorporation of the informal sectors into the legal system does not transform the quality of human capital automatically; it may only provide the means for such enhancement.

The great limitation, not only of the book, but also of De Soto's interpretation as a whole, is that his proposal is more ideological than practical. He argues that capitalist development in the twenty-first century could take place simply as a result of the surplus generated by the formalization of property rights. Despite this limitation, one must give De Soto his due: he has certainly contributed to putting informality on the agenda, albeit from his own perspective.

For these reasons, the book can appeal to both academics and casual readers. From the academic point of view, the empirical evidence that sustains De Soto's arguments is quite weak, which comes as no surprise since *The Other Path* was criticized for this as well.¹ His methodology is particularly problematic. He asked neither workers in the informal sector about what they see as the main obstacles to their advancement, nor those who formalized their activities about how they did it and at what cost. Without such research, this hypothesis remains without empirical corroboration.

From the popular point of view, the book constitutes an essay maintaining that capitalist development is possible in most countries provided the obstacles that De Soto points out are eliminated. He draws from his experience as an international consultant and includes pertinent bibliographical citations to elaborate on a relatively convincing thesis for non-academic readers. It shows the benefits that could accrue from establishing a property system that would turn dead capital into live capital, releasing the potential of the informal sector and the millions of informal workers.

The Empirical Problems of the Mysteries

De Soto's approach consists of putting himself in the place of an informal worker who wants to formalize his property – someone who tries to open a sewing workshop in Lima, for example – and

following all necessary legal steps. he estimates the investment in time and money needed to gain legal title to the property. He estimates that it would take from thirteen to twenty-five years to formalize informal urban property in the Philippines, six to fourteen years to obtain a sales contract in Haiti.

Unfortunately, these estimates are not supported with evidence that allows a comparison with the experiences of people who actually tried to formalize their property. Since bureaucratic procedures in developing countries can be sped up with the aid of friends, contacts, or bribes, it is not clear whether those who formalize follow the same sequence as De Soto. If they incurred high costs in term of time and money, De Soto's hypothesis would be confirmed, but as the research in presented, these is no possibility for rigorous corroboration.

My research in poor neighborhoods of Lima and rural Peru shows that, rather than not being able to formalize their property, the poor do not want to because it is not in their best interest². The cost of formality reduces their income. Their low productivity does not allow them to compete which formal sectors that usually benefit from economies of scale, which the poorer sectors do not enjoy. In this sense, informality offers more protection than hindrance.

The book calculates dead capital at \$9.34 trillion in 179 developing and former-communist countries by multiplying the land occupied by informals by a seemingly average price, whose estimation method is not explained. De Soto may not be aware that one of the great unsolved problems of economics is how to calculate capital. His accounting method is quite weak, since he uses market prices to value informal property. This ignores how markets themselves work: if any significant portion of informal property was sold at once, the price of such property – and thus the return to the owners of this sort of dead capital – would plummet. Ultimately, whether the value of so-called dead capital – is nine trillion or five trillion dollars is not important; what matters is that it creates the illusion that there is an appreciable amount that is wasted or unused to promote development. De Soto's conclusion is blunt: this capital could bring millions of people out of poverty. But is this truly possible?

Let's look more closely at the problem. In the case of Peru, De Soto maintains that the value of extra—legal urban and rural land reaches \$74 billion, almost half the country's physical capital. This would mean that each of the 2.5 million poor Peruvian families would hold \$29,000 in dead capital, which, at a return rate of 15 percent, could produce a profit of \$4,440 per year, or \$370 per month if turned into live capital. This income would hardly reach the poverty level. Although formalization would help the poor greatly, the potential is clearly neither so promising nor so mysterious as the book states.

Furthermore, is it truly possible to transform this stock into other forms of capital so easily? The answer is no, at least not in the magnitude that the author presumes. If informal land were formalized and used as collateral for loans, the Peruvian banking system would not be able to attend

to even a third of this demand, since the current loan portfolio to the formal sector is worth just twenty billion dollars. The situation is probably similar in Haiti and Egypt. Herein lies another obstacle to development that De Soto does not take into account, namely credit scarcity.

The Conceptual Problem: A Solved Mystery

In addition, not every informal property owner is a potential capitalist entrepreneur, or else we would be in a country with no workers. The largest conceptual limitation of De Soto's work is his concept of capital as something dead that can be revived.

The greatest theorists of capitalism, including Adam Smith, David Ricardo, Karl Marx, and Joseph Schumpeter, define capital as a social relation conveyed in objects such as factories, buildings, and fields. Things, or dead capital, obtain value in the market, a social construction, only under certain rules of competition and productivity. Capitalist development consists of the process of socialization of these particular relations of production. The market regulates the production of merchandise and surplus-value by allowing the participation, competitiveness, and endurance of only those producers with productivity close to or better than the social average.

The problem with the informal sector is that it cannot reach the level of productivity necessary to compete because of its scarce human and physical capital, and hence cannot pay direct taxes. Informality is not the result of legal or political obstacles but an economic and social problem, a problem of productivity versus taxes and transaction costs.

The Problems of Neoliberalism in Action

The Neoliberal structural reform undertaken by many developing and former communist countries in the 1990s have not been as successful as many expected, especially the multilateral financial institutions. The 1997 crisis in Southeast Asia spread to nearly every country pursuing very neoliberal politics. De Soto argues that these nations neither reformed nor modernized their property systems and states adequately. Rather, the structural reforms based on the Washington consensus have generated new tensions that can explode in serious social conflicts if, for instance, Marxist ideologies return. De Soto seems to believe his proposals could become an antidote for such an eventuality.

Thus, his book contains a political message as well. It tries to revive the faith in capitalism as the only viable system after a century of sociopolitical and economic experiments. He argues for the valorization of dead capital in countries where neoliberal adjustments have been unsuccessful. To accomplish this, he proposes "second-generation reforms", such as administrative reform, the creation of inclusive property systems, and the full participation of informals or extra-

legals in the economy. In addition, he implicitly suggests new formulas for political participation that give the book an aura of “third way” liberal policies by an understanding and cooperative state. Such a proposal is clearly very attractive for the wilted neoliberal agenda, damaged after a decade of only modestly successful experiments in Latin America, Eastern Europe, and Africa. The wave of protest in Seattle, Washington, and Prague during summits of the multilateral financial institutions constitutes a testimony and a warning for neoliberalism.

The book is an ideological proposal to renew liberalism by creating a modern state. Ideology is a body of ideas that uphold the interests of the dominant groups or sectors in a particular country or society. De Soto’s proposal fits into a system of neoliberal ideology so popular that some call it “the only thought” that favors the established global capitalist order. More importantly, the complete formalization of property would not only valorize dead capital but would also result in social homogenization by the inclusion of all the population into the capitalist system. De Soto proposes a system of representation based on the idea that property generates surplus, capital, and wealth. These ideas could bring the different sectors of society together and, moreover, encourage development and increase welfare. His proposal of formalization would be a sort of revolution without social convulsion, attainable by sheer political will and perseverance. De Soto’s arguments are attractive for developing countries whose governments have little clue as to how to solve the problems of poverty and social exclusion. Social inclusion through the formalization of property and its valorization is therefore a tempting idea.

The problem is that not all of these ideas withstand the reality check. A characteristic of ideologies is that they emphasize facts that benefit certain interests, failing to provide a wide view of reality. De Soto’s argument suffers from such shortcomings. Governments have to undertake more changes than he contemplates in order to promote capitalist development.

Reality Check

He maintains mistakenly that Peru has not advanced in the formalization path at all since proposals contained in *The Other Path* were undertaken a decade ago. With the support of the World Bank and the Inter-American Development Bank, Fujimori’s government developed projects for property formalization, modernization of property registries, reform of administrative procedures, and financial openness, a recipe similar to the one in *The Mysteries of Capital*. The Peruvian government has formalized the property of more than one million rural people, and its Commission of Property Formalization, which De Soto helped create, has also accomplished much in urban shantytowns.

Yet this has not translated into massive demand for mortgage loans based on titled properties for rural or urban investment. Worse, the levels of rural and urban poverty have increased

to 1990-91 averages. Well-titled properties and a credit offer are not enough. Banks require that loan applicants show that their prospective businesses are productive, profitable, and sustainable – that is, socially necessary. In short, development needs additional measures that De Soto's theory does not take into consideration.

Showing a little cheek, De Soto cites Karl Marx and recognizes his status as one of the principal theorist of capitalism even though his predictions have failed. While Marx maintains that only socially necessary labor creates value and capital, De Soto also attributes such characteristics to property. Thus for Marx³ the institutional framework, including property rights, is the result of material changes in production, whereas De Soto sees it the opposite way: better institutional conditions can improve material conditions. For De Soto, institutions are exogenous, while they are endogenous for Marx and Douglas North⁴. De Soto's proposal is based on philosophical view that it is necessary to formalize to develop, rather than to develop in order to formalize.

The heart of the problem is why dead capital should be revived. It is dead because it cannot survive alongside "living" formal capital because of technological problems, low human capital, and other factors that De Soto ignores. If dead capital becomes competitive, the market will push it automatically to formalization. Thus, material development has to precede institutional development.

In short, De Soto's book is not as mysterious as its title suggests. It is just a bit more of the recipe contained in *The Other Path*. Its main strength is the ideological message that there are possibilities of development within capitalism, even for the poorest countries, though institutional frameworks impede it. Consequently, the answers for developing countries to the mystery of development are institutional reform, state modernization, and the resuscitation of dead capital. Western countries have already done this with success, says De Soto. But in fact, what is mysterious is not why some countries have developed while many have not, but why the models or recipes of the former are not transferable to the latter. This continues to be a mystery, especially in De Soto's book.

Notes

¹ See Rossini, Renzo G. and Jim Thomas, *Los fundamentos estadísticos de "El Otro Sendero"*. *Debate sobre el Sector Informal en el Perú* (Lima: Fundación Friedrich Ebert, 1987) p.74.

² Gonzales de Olarte, Efraín, *En las Fronteras del Mercado. La Economía Política del Campesinado en el Perú* (Lima: Instituto de Estudios Peruanos. Análisis Económico 16, 1994) Gonzales de Olarte, Efraín. *La economía regional de Lima: Crecimiento, urbanización y clases populares*, (Instituto de Estudios Peruanos, Análisis Económico 15, 1991).

³ Marx, Karl, *Das Kapital*, volume 1, various editions in several languages.

⁴ North, Douglas C. *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).