

# Property, Markets, and Capitalism in the Third World

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**Based on: Hernando deSoto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (2000).**

Hernando deSoto, a Peruvian economist, has attracted considerable attention in the public policy and development communities with his book, *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE*. deSoto describes and resolves a number of “mysteries.” Why is it, he asks, that despite substantial entrepreneurial energy, the existence of abundant natural resources, and excess labor, developing countries such as Egypt, Peru, Columbia, Ukraine, Kosovo and others, seem unable to make the transition to prosperous market economies.

The answer, he argues, is that they “hold ...resources in defective forms: houses built on land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, industries located where financiers and investors cannot see them.” Because property rights are not adequately documented, they cannot “readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment.” In contrast, western nations have sophisticated legal infrastructures that permit property to be turned into capital.

Because property-law systems in developing countries are so cumbersome as to be dysfunctional, economic activity is driven into an informal, extra-legal sector. deSoto documents the barriers. In Peru, for example, he and his research team opened a small garment workshop as an experiment in meeting the requirements for a new, and entirely legal, business. Although the shop was organized to operate with only one worker, it took 289 days and legal costs 31 times the minimum monthly wage to register the business. To obtain authority to build a house on state owned land took 6 years and 11 months, and 207 administrative steps in 52 governmental offices. Obtaining legal title to the land took 728 steps.

Someone in the Philippines who wants to formalize informal urban property must follow 168 steps over a period of 13-25 years. Someone in Egypt who wants to obtain access to desert land for construction purposes must follow 77 steps with 31 different governmental entities over a period of 6 to 14 years. In Haiti it takes 111 steps and 4,112 days to obtain a five-year lease contract.

Few people have the resources or the patience to navigate their way through such a labyrinth. Accordingly they “live and work outside the official law, using their own informally binding arrangements to protect and mobilize their assets.” But they do not retreat into idleness.

“Undercapitalized sectors throughout the third world and in former communist countries buzz with hard work and ingenuity. Street-side cottage industries have sprung up everywhere, manufacturing anything from clothing and footwear to imitation Cartier watches and Vuitton bags. There are workshops that build and rebuild machinery, cars, even buses. The new urban poor have created entire industries in neighborhoods that have to operate on clandestine connections to electricity and water.”

The cost of relying on these informal arrangements is undercapitalization. Entrepreneurs cannot pledge their assets to obtain money from investors because the assets have no legal status. “A legal failure that prevents enterprising people from negotiating with strangers defeats the division of labor and fastens would-be entrepreneurs to smaller circles of specialization and low productivity.” Moreover, relying on informal extended-family, clan, and ethnic group muscle to protect assets increases the likelihood of interethnic conflict as in the Balkans.

deSoto’s views are consistent with those of other development economists, such as Dani Rodrik, who present empirical evidence that the main determinant of economic progress in developing countries is the “acquisition of high-quality institutions.”

deSoto contrasts these circumstances with those prevailing in the west where

“Every asset—every piece of land, every house, every chattel—is formally fixed and updated records governed by rules contained in the property system. Every increment in production, every new building, product, or commercially valuable thing is someone’s formal property. Even if assets belong to a corporation, real people still own them indirectly, through titles certifying that they own the corporation as ‘shareholders.’”

deSoto perceives six characteristics of Western property-law systems that allow assets to generate capital:

1. They fix the economic value of assets
2. They integrate disbursed information into one system
3. They make people accountable.
4. They make assets fungible
5. They allow people to network
6. They protect transactions.

Part of the problem, he argues, is insufficient consciousness about transitions in western societies, especially in the United States, from informal systems to organize economic activity into more formal arrangements. As he explains the American west was settled

mostly by squatters who lacked clear title and who protected the fruits of their labor with fists and guns wielded by their extended families and networks of friends.

The problem in developing countries is, with a few exceptions such as Somalia, where there is no government at all, not the absence of formal property-law systems on paper; the problem is lack of accessibility to those systems.

He argues that the solution is as much political as legal. Policymakers in developing countries and in the international community which seeks to assist them must move beyond concern with macro policies and generalized commitments to rule of law and markets. They must concern themselves with the details of how property-law systems work. They must reduce the transaction cost for poor people to participate in the formal legal system. They also must adopt property-law doctrines that permit entrepreneurial energy exerted by those now in the informal sector to be turned into formal property rights, which will require mechanisms to resolve in a reasonably certain way competing claims by those who work the land against those who own it under existing formal property doctrines.

It is far from clear exactly how this can be done in a way that does not increase political instability. There are, however, some interesting models in U.S. property law such as the doctrines of adverse possession and easement by prescription, which turn potentially productive conduct into legal rights, even at the expense of those with competing prior legal rights.

deSoto's insights should shape the perspectives of any student of American property law. They should encourage attention to those features of the American property system that facilitate low-cost access to the property-law system, to features that enhance certainty of title, and to features that facilitate creation of property rights for someone who starts out propertyless but invests his or her labor in creating value.