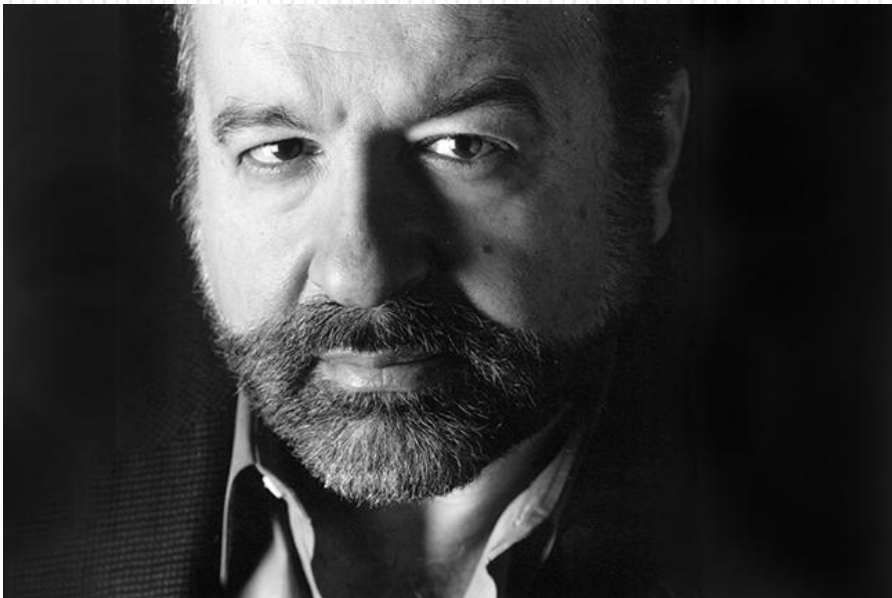


Mystery of Capital:  
Why Capitalism Triumphs in the West and  
Fails Everywhere Else



By

Hernando De Soto

# INTRODUCTION

- Background of enquiry: post cold war
- Stumbling block: inability to produce capital for domestic capitalism
- Poor own assets, in defective form: houses, but not titles; crops, but not deeds; businesses, but not statutes of incorporations
- Without **representations**, assets are dead capital

# What is Capital?

- Capital is an abstract ability of any asset which will result in additional production.
- The only way to touch the capital is if the property system can record its economic potential on paper and anchor them to a specific location and owner.

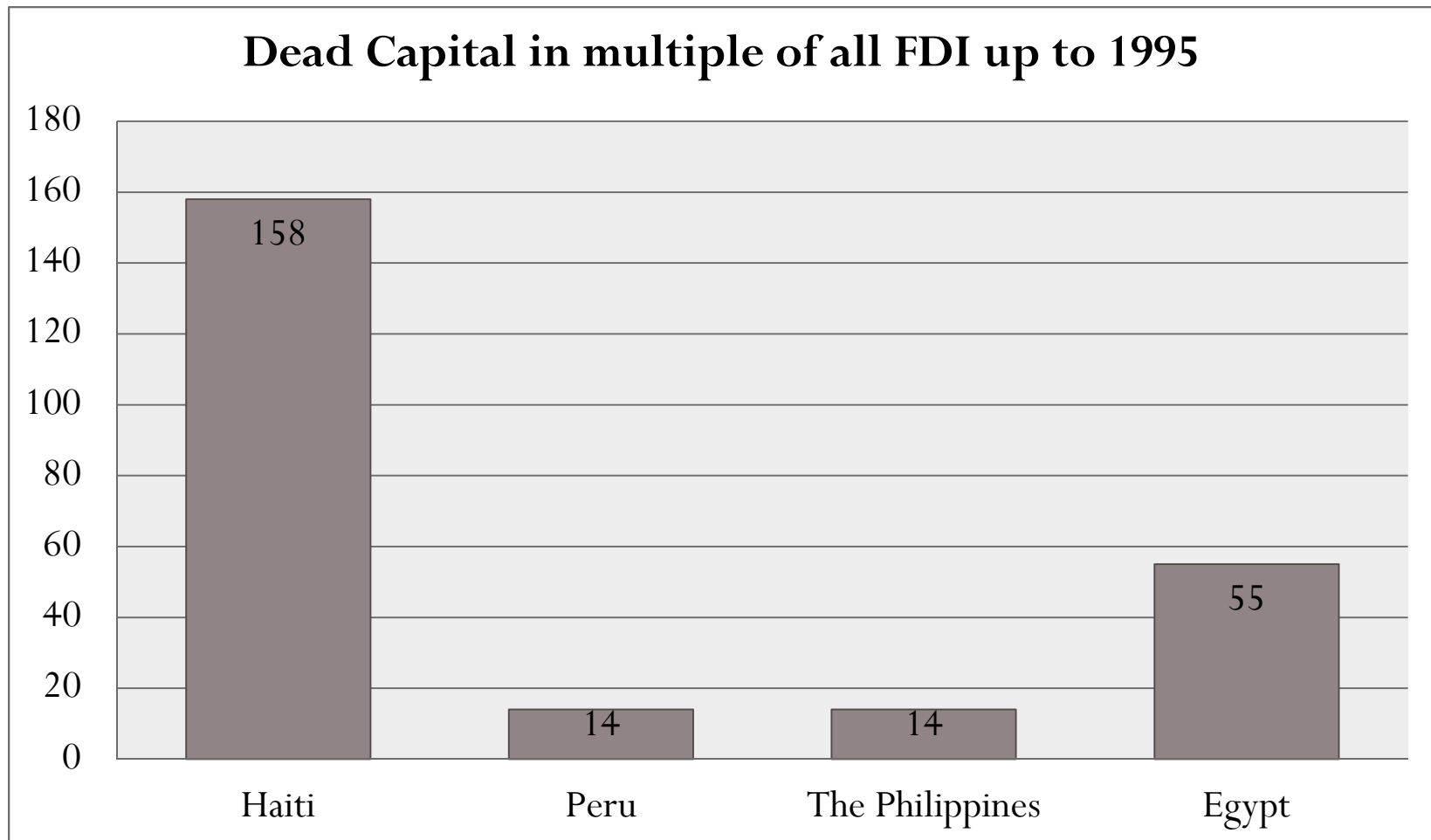
# Dead Assets and Capital

- Any asset requires the conversion process to become capital
- Those assets not converted into capital are called “Dead Assets”
- That conversion process is somehow unfeasible in developing and former communist countries

## Informal Sectors

- ✦ **A Surprise Revolution:** Huge rural migration.
  - e.g. in China, since 1979 100 million rural people have moved to the cities.
- ✦ **The obstacles to legality:** On the basis of field surveys, in Egypt, Haiti, Peru, Philippines and Mexico, number of years and number of steps for getting approvals related to property have been described, so you have extralegals.
- ✦ **The undercapitalized sector:** These extralegal social contracts have created a vibrant but “undercapitalized sector” (street vendors, apartment building workers, garbage collectors)
- ✦ **How much dead capital?:** Examples from 5 Third World cities (Cairo, Lima, Manila, Mexico and Port-au-Prince) show that most people’s resources are commercially and financially invisible.
- ✦ **How much is dead capital worth?:** \$9.3 trillion.

# How Much is the Dead Capital Worth?



# The Mystery of Capital

- The mystery: Why can assets be made to produce abundant capital in the West but very little in the rest of the world?
- What do we mean by capital?
- What role do formal property systems play?
- Why does this matter?

# The Mystery of Capital

- Capital affects a country's ability to initiate surplus and increase productivity.
- Historically, capital began to do 2 jobs simultaneously – capturing physical dimension of assets (originally livestock) and their potential to generate surplus value.
- De Soto emphasizes that capital is NOT accumulated stock of assets but the potential that these held assets have to deploy new production.

# The Mystery of Capital

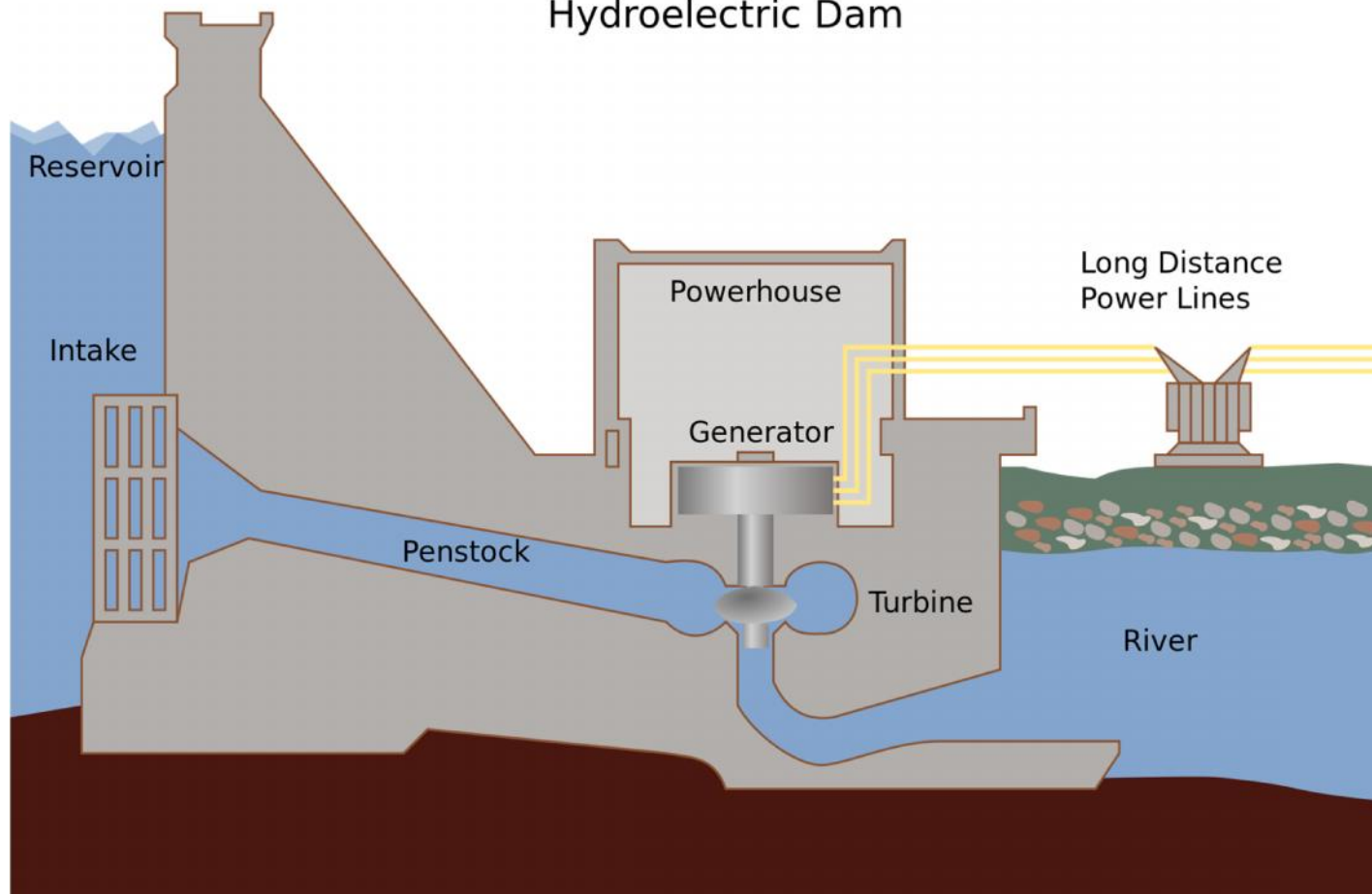
- Capital is also not money, which is one of the ways in which it travels but is not the only way. The challenge in non-Western countries is that this is more vague and intangible than in the West.
- To be of use, assets must be transformed into tangibles. Dead capital exists because we have forgotten (or never realized) that using a physical asset to generate capital requires a very complex process. Formal property systems are important because they enable capital to be productive.

# Fixing Assets into Capital



# Fixing Assets into Capital

Hydroelectric Dam



# Fixing an Asset's Economic Potential

- In order to fix an asset into a form that can be used to initiate additional production, we need a formal property systems
- Formal property systems were not set up to create capital but for a more mundane purpose of protecting property ownership.
- Thus, the conversion process has been ignored for a long time.

# Braudel's Bell Jar

- “Some investors’ assets are integrated, fungible, networked and protected by formal property system. But they are only a minority”
- “The great majority of people, who cannot benefit from formal property system, live outside the bell jar”



# Extralegality

- Extralegal is when someone quits the system and live and work outside the official law
- Extralegal areas have their own rules which are enforced by their own selected authorities
- Extralegal settlers, share the desire of civil society to lead peaceful, productive life. However they have no access to credits.

# Extralegal Zone



Extralegal zones are characterized by modest homes cramped together, myriad of illegal workshops and armies of vendors on the streets

# Legal VS Extralegal

- Governments' attempts to deny the extralegal systems were plentiful, harsh and sometimes, deadly. Only to protect legally established industries.
- More laws were passed to prosecute those extralegals
- More obligations, more extralegality

# Problem was the Law, Not People

- As the poor flow into the city and create extralegal social contracts, they are forcing a major redistribution of power
- Politicians began to realize that official law will not make sense if the majority of people (extralegal) do not benefit from it
- Law must be adapting to the reality of a massive extralegal push toward widespread property right

# Formal Property Systems

- 1. Fixing the economic potential of an assets** – Capital is born by representing in a title or other such records
- 2. Integrating dispersed information into one system** – Assets must be integrated into one formal property system
- 3. Making people accountable** – Formal property created individuals from masses

## Formal Property Systems(cont'd)

4. **Making assets fungible** – Able to split their assets into shares, owned by different persons, with different rights to carry out different functions
5. **Networking people** – Formal property systems allow assets to run safely between people
6. **Protecting Transactions** – Allow citizens to move large amount of assets with very few transactions

# Mystery of political awareness

- Political blindness-
  - Unaware of the growth of extralegal sector and breakdown of existing legal order
  - Problems are not new

# Mystery of political awareness

- Problem-
  - Worldwide industrial revolution-gigantic movement (migration) from isolated communities to participate in wide scale economic exchange
  - Failure of legal order to keep pace/ lack of institutions- forcing migrants to set up extralegal substitutes for established law
  - Fragmentation of property rights arrangements and unavailability of standard norms prevent interaction with the financial and investment markets

# Mystery of political awareness

- Solution-
  - Piecemeal solutions and stopgap measures not sufficient
  - Need to integrate property systems and reform laws that are discouraging and preventing people from being more productive
  - Laws need to adapt to the needs of the common people, including their expectations about property rights

# Problems with Legal Property Right

- In acquiring legal property rights, one might have to go through hundreds of steps and it takes more than ten years
- It is very nearly as difficult to stay legal as it is to become legal
- There came “Extralegals”

FIGURE 2.3 Procedure to gain access to desert land for construction purposes and to register these property rights in Egypt (6–14 years)

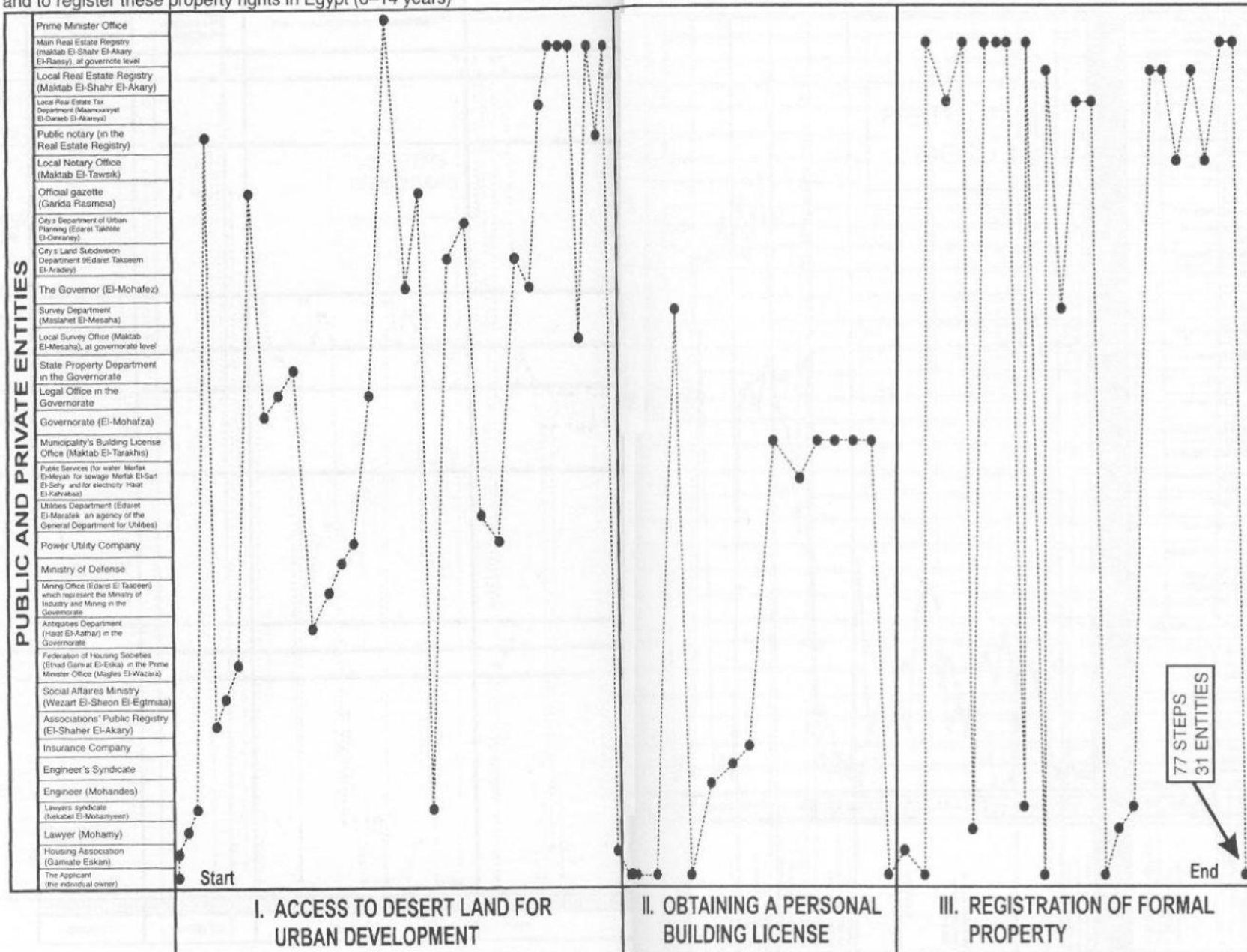
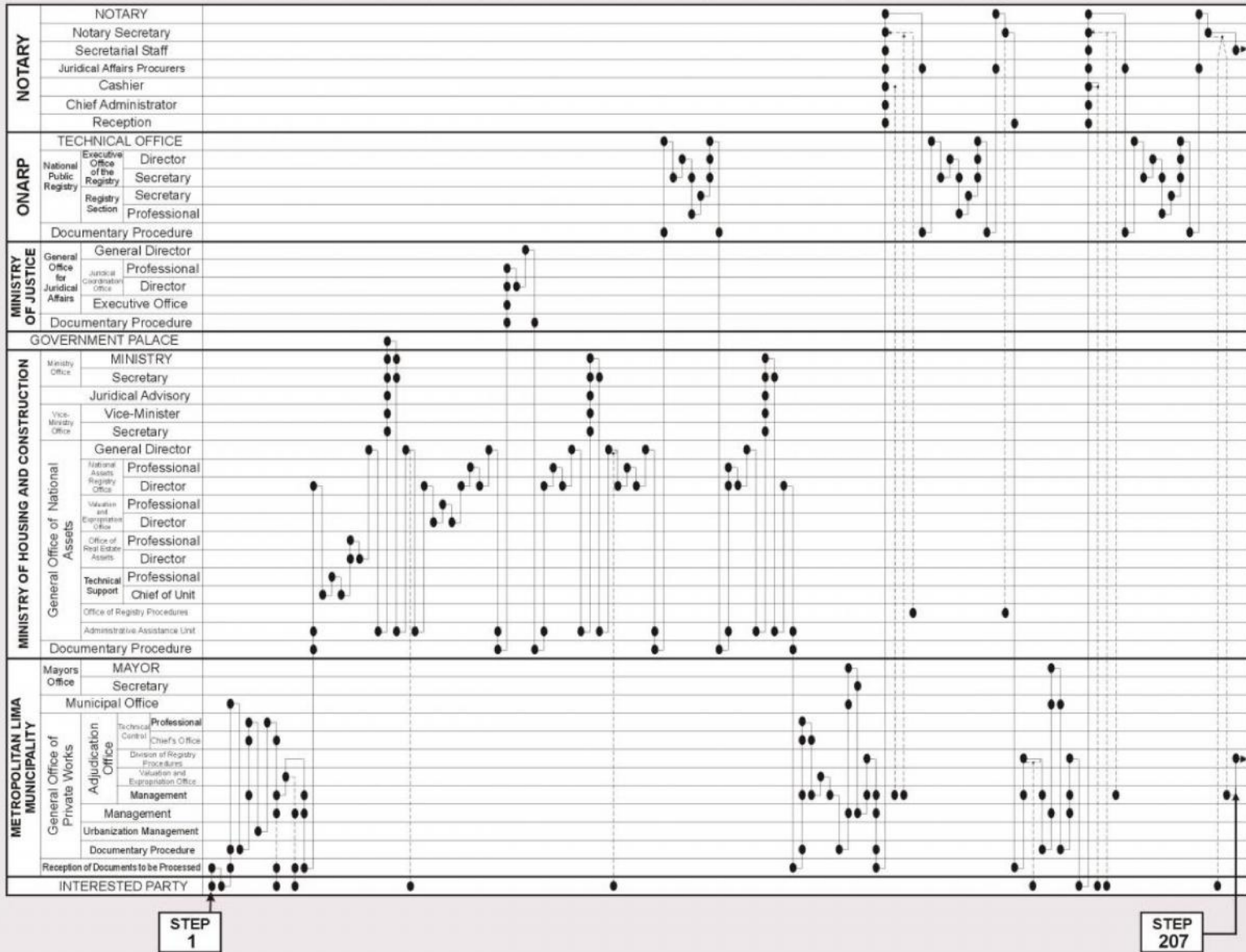


Figure 1

**PROCEDURES TO FORMALIZE A LEGALLY OBTAINED HOME IN PERU CONSIST OF 5 STAGES; THE FIRST ONE ALONE INVOLVES 207 STEPS**



# Lesson From U.S. History

- At the very first of its time United States politicians had to deal with migrants illegally owning the land (squatters)



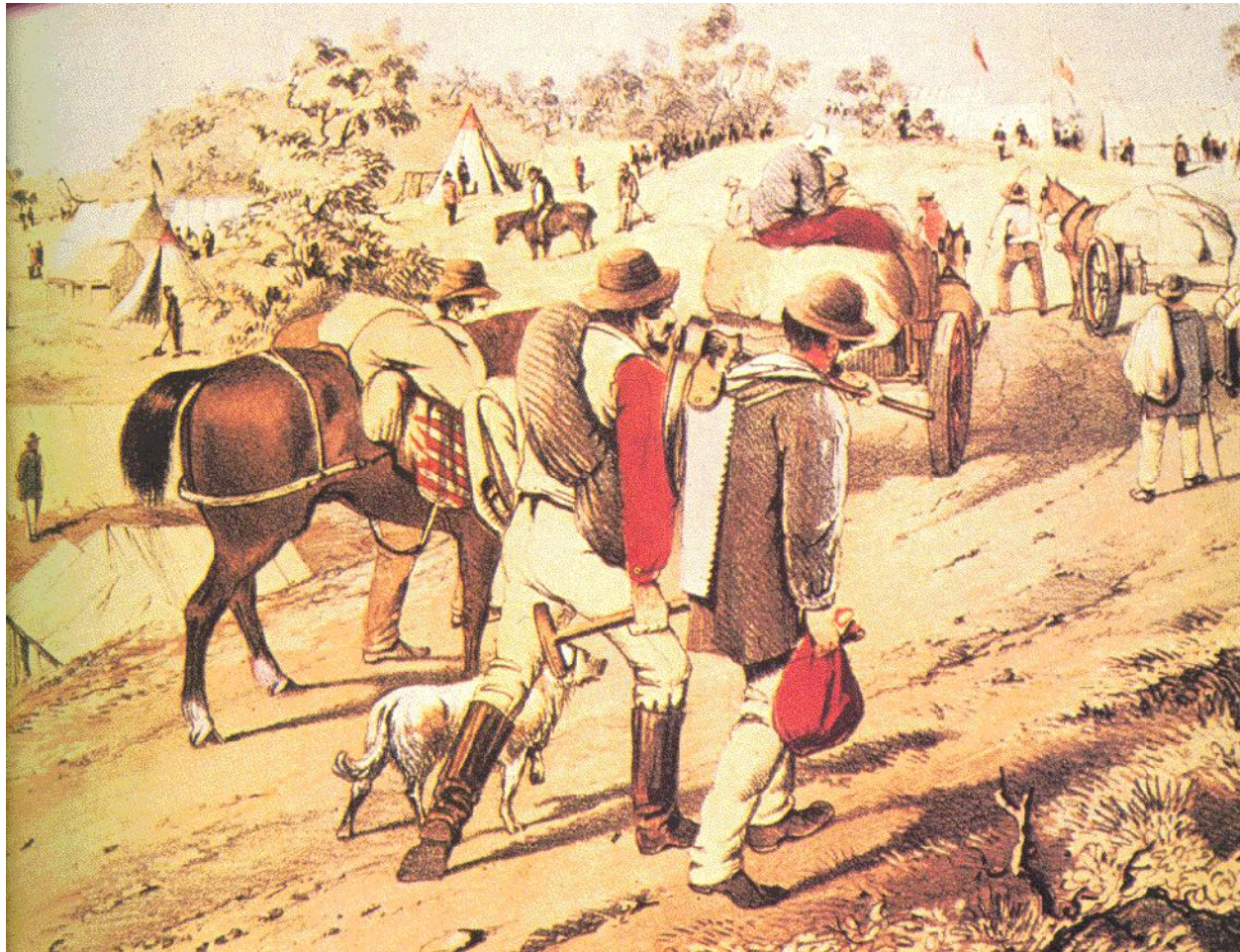
# The New Social Contracts

- These squatters had to establish some sort of orders even if it had to be outside the official law such as:
- Tomahawk right – by deadening a few trees and marking the bark of those trees
- Cabin right and Corn right – staking out land by building a log cabin or raising a crop of corn

# Legal Breakthrough: Preemption (1830)

- Colonial Authorities began to realize how difficult it was to apply English common law on new settlers
- Unlike English law, squatters who have improved the land which legally belongs to others can have the compensation
- If the rightful owner is unwilling to reimburse the squatters for the improvements, the squatter could purchase the land at a price set by a local jury

# California Gold Rush (1848-1855)



# California Gold Rush (1848-1855)

- By the end of the year 1849, the non-native population of California was estimated at 100,000, (as compared with 20,000 at the end of 1848 and around 800 in March 1848)
- By 1855, it is estimated at least 300,000 gold-seekers, merchants, and other immigrants had arrived in California from around the world
- These gold-seekers were basically “trespassers” to the land which most of it belong to the federal government

# Extralegal Organizations in the U.S.

These extralegal organizations performed a range of functions, from negotiating with the government to registering the properties rights that squatter claimed

1. Claim Associations – helped protect properties rights from claim jumpers and speculators outside the group
2. Miners' Organizations – like claim associations. Negotiating among themselves, they work to protect their rights and increase the value of their properties.

# 1866 Legislation for Miners

- Congress for the first time declared the nation's mineral lands officially open for exploration to U.S. citizens
- The principle was: the recognition of miners' laws, and the right of anyone who improved a mine to purchase the title from the government at a reasonable price
- Extralegal arrangements of both miners and squatters, are now integrated into one formal property system.

# Homestead Act

- In 1862 the Homestead Act was passed which would give 160 free acres to any settler willing to live on the land for five years and develop it
- The act was the symbol signifying the end of a long, exhausting and bitter struggle between elitist law and new order brought about by massive migration

# The Only Game In Town

- Capitalism can succeed in the developing countries, provided that the governments accept the following:
  1. The situation and potential of the poor need to be better documented
  2. All people are capable of saving
  3. What the poor are missing are the legally integrated property systems that can convert their work and savings into capital

# The Only Game In Town

4. Civil disobedience and the mafias of today are not marginal phenomena but the result of people marching by the billions from life organised on a small scale to life on a big scale
5. In this context, the poor are not the problem but the solution
6. Implementing a property system that creates capital is a political challenge because it involves getting in touch with people, grasping the social contract, and overhauling the legal system

# The Only Game In Town

- To De Soto, those much more important than capitalism are freedom, compassion for the poor, respect for social contracts and equal opportunity
- But to achieve those goals, capitalism is the only game in town.