

HERNANDO DE SOTO

The Mystery of Capital

WHY CAPITALISM TRIUMPHS IN THE
WEST AND FAILS EVERYWHERE ELSE

A hugely persuasive and
important book, the more so
because of the moving
simplicity of its central idea

DAILY TELEGRAPH

'A revolutionary book . . . if the criterion is
a capacity not only to change permanently
the way we look at the world, but also to
change the world itself, then there are good
grounds for thinking that this book is
surely a contender . . . thrillingly subversive'

DONALD MACINTYRE, *Independent*

Why does capitalism
triumph in the West but
fail almost everywhere
else? Elegantly, and
with rare clarity,
Hernando de Soto
revolutionizes our
understanding of what
capital is and why it
does not benefit
five-sixths of mankind.
He also proposes a
solution: enabling the
poor to turn the vast
assets they possess
into wealth.

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completely convincing'

RONALD COASE, Nobel Laureate in Economics

'A crucial contribution. A new proposal for
change that is valid for the whole world'

JAVIER PEREZ DE CUELLAR,

former Secretary-General of the United Nations

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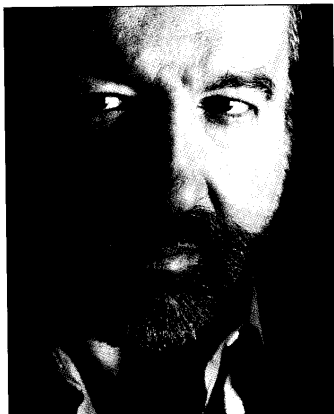


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Hernando de Soto, a Peruvian, is the founder and President of the Institute of Liberty and Democracy (ILD) in Lima, regarded by *The Economist* as the second most important think-tank in the world. He was recently listed by *Time* magazine as one of the five leading Latin American innovators of the twentieth century. He has also been an economist for GATT (now WTO), CEO of one of Europe's largest engineering firms, and a governor of Peru's Central Reserve Bank. As President Alberto Fujimori's Principal Advisor, he initiated Peru's economic reforms and played a leading role in modernizing its economic and political system. In 1993 de Soto drew up and negotiated the strategic plan that reversed Fujimori's coup d'état and returned the country to electoral democracy. He and the ILD are currently working in Asia, the Middle East and Latin America on the practical implementation of the measures for bringing the poor into the economic mainstream introduced in *The Mystery of Capital*. His previous book, *The Other Path*, was published in more than ten languages and was a number one bestseller throughout Latin America.

More information on Hernando de Soto and the ILD can be found at www.ild.org.pe

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'Few people in Britain have heard of Hernando de Soto ... but *The Mystery of Capital* has already led the cognoscenti to put him in the pantheon of great progressive intellectuals of our age ... the basis of de Soto's thinking is that property ownership is the key to ending poverty – but that it will work only if the poor can use their property to generate further wealth. Capitalism, he argues, has not failed outside the west for any of the reasons usually given: cultural differences, lack of enterprise, religion, fecklessness or laziness. On the contrary, the developing world buzzes with hard work, entrepreneurial skill and ingenuity. As a result, the poor are not really poor at all. They own trillions of pounds worth of assets'

Mark Leonard, *New Statesman*

'A very great book ... powerful and completely convincing. It will have a most salutary effect on the views held on economic development'

Ronald Coase, Nobel Laureate in Economics

'Land and property ownership has long been identified as a prerequisite for economic development, but de Soto has given vivid flesh to that theory. With the problem identified, the solution – creating proper national legal systems as in the west – is a matter of political will. In a book which is fastidious in its search for the facts but passionate in spirit and language, de Soto gives it no less than the blueprint for a new industrial revolution that will mobilise the entrepreneurial vigour and hidden wealth of the poor and tear up the conventional wisdoms of the development debate in the process'

The Times

'A crucial contribution. A new proposal for change that is valid for the whole world'

Javier Perez de Cuellar, former Secretary-General of the United Nations

'Hernando de Soto is a revolutionary intellectual but not the usual kind ... He has a profound message ... Mr de Soto's revolution cuts several different ways'

Wall Street Journal

'De Soto has single-handedly been fomenting a revolution in the Third World ... *The Mystery of Capital* documents his rich practical insights from decades of experience in the field, and constitutes one of the few new and genuinely promising approaches to overcoming poverty to come along in a long time'

Francis Fukuyama, author of *The End of History* and *The Last Man*

'A brilliant and illuminating book. Its empirical foundations are truly exceptional. By slogging away in the shanty towns of Lima, Port-au-Prince, Cairo and Manila, he and his researchers have established that, although their incomes are low, the poor of the world have a surprisingly large amount of property. The problem is that this property is not legally recognised as theirs. It is nearly all held "extralegally"'

Niall Ferguson, *Literary Review*

'Revolutionary ... what de Soto has done is document the extraordinary vitality and scale of what he calls the extra-legal economy in the developing world and the former communist countries and then suggest ways of demolishing the barriers which still exclude its billions of protagonists from sharing in the spoils of conventional global capitalism ... thrillingly subversive in the way it demolishes some of the standard myths about Third World poverty – first and foremost that of "culture"'

Donald MacIntyre, *Independent*

'In modern times there have arguably been four big ideas for improving the lot of the world's poor ... the fourth is this eloquent thesis by Hernando de Soto ... a hugely persuasive and important book, the more so because of the moving simplicity of its central idea'

Martin Vander Weyer, *Daily Telegraph*

'*The Mystery of Capital* has the potential to create a new, enormously beneficial revolution, for it addresses the single greatest source of failure in the Third World and ex-Communist countries – the lack of a rule of law that upholds private property and provides a framework for enterprise. It should be compulsory reading for all in charge of the wealth of nations'

Baroness Thatcher

'Fresh thinking is rare – this book has the capacity to transform the economies of those countries who have hitherto not been able to make capitalism work for their people ... it explains how economies fail that have not first created the vital legal structures nor let the "black" economy come into the mainstream economy'

Lord Owen, former British Foreign Secretary

'Hernando de Soto has demonstrated in practice that titling hitherto untitled assets is an extremely effective way to promote economic development. He offers politicians a project which can contribute to the welfare of their country and at the same time enhance their own political standing, a wonderful combination'

Milton Friedman, Nobel Laureate in Economics

'De Soto's commonsense simplicity, laid out in his latest book, *The Mystery of Capital*, has heads of state from Haiti to Pakistan lining up for his advice'
Time.com

'We recommend it to our many readers who have little idea of the problems that the majority of the world's population faces in their own rush for "capitalism"'
UpsideToday

'In the last 15 years, Mr de Soto, 59, has revolutionized the way governments view poverty, and has become one of the world's leading advocates for the poor'
National Post online

'Hernando de Soto provides a powerful explanation for the peculiar triumph of the West . . . De Soto makes a very powerful point, based on results from his international network of researchers . . . Clear understanding of the processes of prosperity, and what is at stake, is also a great weapon in the endless fight against the rent-seeking enemies of prosperity. By providing such clear understanding, de Soto's powerful and immensely readable book is a very great weapon in the armoury of freedom'
Policy

'The most intelligent book yet written about the current challenge of establishing capitalism in the developing world. Mr de Soto draws lessons from America's capitalist development to show what needs to be done. Above all, developing nations must recognise and protect the property that many poor people have created, but which is currently of uncertain legal validity, and thus is of little use in securing the loans necessary to invest in personal or business development'
The Economist

Also by Hernando de Soto

THE OTHER PATH

THE MYSTERY OF CAPITAL

WHY CAPITALISM TRIUMPHS IN THE WEST
AND FAILS EVERYWHERE ELSE

Hernando de Soto



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To Mariano Cornejo, who showed me how to stand firmly
on the ground, and to Duncan Macdonald, who taught me
how to navigate by the stars.

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3

THE MYSTERY OF CAPITAL

The sense of the world must lie outside the world. In the world everything is as it is and happens as it does happen. In it there is no value – and if there were, it would be of no value.

If there is a value which is of value, it must lie outside all happening and being-so. For all happening and being-so is accidental.

What makes it non-accidental cannot lie in the world, for otherwise this would again be accidental.

It must lie outside the world.

LUDWIG WITTGENSTEIN, *Tractatus Logico-Philosophicus*

Walk down most roads in the Middle East, the former Soviet Union or Latin America, and you will see several things: houses used for shelter, parcels of land being tilled, sowed and harvested, merchandise being bought and sold. Assets in developing and former communist countries primarily serve these immediate physical purposes. In the West, however, the same assets also lead a parallel life as capital outside the physical world. They can be used to put in motion

more production by securing the interests of other parties as 'collateral' for a mortgage, for example, or by assuring the supply of other forms of credit and public utilities.

Why can't buildings and land elsewhere in the world also lead this parallel life? Why can't the enormous resources we discussed in Chapter 2 – \$9.3 trillion of dead capital – produce value beyond their 'natural' state? My reply is: Dead capital exists because we have forgotten (or perhaps never realized) that converting a physical asset to generate capital – using your house to borrow money to finance an enterprise, for example – requires a very complex process. It is similar to the process that Einstein taught us whereby a single brick can be made to release a huge amount of energy in the form of an atomic explosion. By analogy, capital is the result of discovering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings.

There is, however, one crucial difference between unleashing energy from a brick and unleashing capital from brick buildings: while humanity (or at least a large group of scientists) has mastered the process of obtaining energy from matter, we seem to have forgotten the process that allows us to obtain capital from assets. The result is that 80 per cent of the world is undercapitalized; people cannot draw economic life from their buildings (or any other asset) to generate capital. Worse, the advanced nations seem unable to teach them. Why assets can be made to produce abundant capital in the West but very little in the rest of the world is a mystery.

THE MYSTERY OF CAPITAL

Clues from the Past (from Smith to Marx)

To unravel the mystery of capital, we have to go back to the seminal meaning of the word. In medieval Latin 'capital' appears to have denoted head of cattle or other livestock, which have always been important sources of wealth beyond the basic meat they provide. Livestock are low-maintenance possessions; they are mobile and can be moved away from danger; they are also easy to count and measure. But most important, from livestock you can obtain additional wealth, or surplus value, by setting in motion other industries, including milk, hides, wool, meat and fuel. Livestock also have the useful attribute of being able to reproduce themselves. Thus the term 'capital' begins to do two jobs simultaneously, capturing the physical dimension of assets (livestock) as well as their potential to generate surplus value. From the barnyard, it was only a short step to the desks of the inventors of economics, who generally defined 'capital' as that part of a country's assets that initiates surplus production and increases productivity.

Great classical economists such as Adam Smith and Karl Marx believed that capital was the engine that powered the market economy. Capital was considered to be the principal part of the economic whole – the pre-eminent factor as in such phrases as *capital* issues, *capital* punishment, the *capital* city of a country. They wanted to understand what capital is and how it is produced and accumulated. Whether you agree with the classical economists or not, or perhaps view them as irrelevant (maybe Smith never understood that the Industrial Revolution was under way, maybe Marx's labour theory of value has no practical application), there is

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no doubt that these thinkers built the towering edifices of thought on which we can now stand and try to find out what capital is, what produces it and why non-Western nations generate so little of it.

For Smith, economic specialization – the division of labour and the subsequent exchange of products in the market – was the source of increasing productivity and therefore 'the wealth of nations'. What made this specialization and exchange possible was capital, which Smith defined as the stock of assets accumulated for productive purposes. Entrepreneurs could use their accumulated resources to support specialized enterprises until they could exchange their products for the other things they needed. The more capital was accumulated, the more specialization became possible, and the higher society's productivity would be. Marx agreed; for him, the wealth capitalism produces presents itself as an immense pile of commodities.

Smith believed that the phenomenon of capital was a consequence of man's natural progression from a hunting, rural and agricultural society to a commercial one where, through interdependence, specialization and trade, he could increase his productive powers immensely. Capital was to be the magic that would enhance productivity and create surplus value. 'The quantity of industry', wrote Smith, 'not only increases in every country with the increase of the stock [capital] which employs it, but, in consequence of that increase, the same quantity of industry produces a much greater quantity of work.'¹

Smith emphasized one point that is at the very heart of the mystery we are trying to solve: for accumulated assets to become active capital and put additional production in motion, they must be *fixed and realized in some particular*

subject 'which lasts for some time at least after that labour is past. It is, as it were, a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion.'² Smith warned that labour invested in the production of assets would not leave any trace or value if not properly fixed.

What Smith really meant may be the subject of legitimate debate. What I take from him, however, is that capital is not the accumulated stock of assets but the *potential* it holds to deploy new production. This potential is, of course, abstract. It must be processed and fixed into a tangible form before we can release it – just like the potential nuclear energy in Einstein's brick. Without a conversion process – one that draws out and fixes the potential energy contained in the brick – there is no explosion; a brick is just a brick. Creating capital also requires a conversion process.

This notion – that capital is first an abstract concept and must be given a fixed, tangible form to be useful – was familiar to other classical economists. Simonde de Sismondi, the nineteenth-century Swiss economist, wrote that capital was 'a permanent value, that multiplies and does not perish . . . Now this value detaches itself from the product that creates it, it becomes a metaphysical and insubstantial quantity always in the possession of whoever produced it, for whom this value could [be fixed in] different forms.'³ The great French economist Jean Baptiste Say believed that 'capital is always immaterial by nature since it is not matter which makes capital but the value of that matter, value has nothing corporeal about it'⁴. Marx agreed; for him, a table could be made of something material, like wood, 'but so soon as it steps forth as a commodity, it is changed into something

transcendent. It not only stands with its feet on the ground, but, in relation to all other commodities, it stands on its head, and evolves out of its wooden brain grotesque ideas, far more wonderful than table-turning ever was.'⁵

This essential meaning of capital has been lost to history. Capital is now confused with money, which is only one of the many forms in which it travels. It is always easier to remember a difficult concept in one of its tangible manifestations than in its essence. The mind wraps itself around 'money' more easily than 'capital'. But it is a mistake to assume that money is what finally fixes capital. As Adam Smith pointed out, money is the 'great wheel of circulation', but it is *not* capital because value 'cannot consist in those metal pieces'.⁶ In other words, money facilitates transactions, allowing us to buy and sell things, but it is not itself the progenitor of additional production. As Smith insisted, 'the gold and silver money, which circulates in any country, may very properly be compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either'.⁷

Much of the mystery of capital dissipates as soon as you stop thinking of 'capital' as a synonym for 'money saved and invested'. The misapprehension that it is money that fixes capital comes about, I suspect, because modern business expresses the value of capital in terms of money. It is hard to estimate the total value of a collection of assets of very different types, such as machinery, buildings and land, without resorting to money. After all, that is why money was invented; it provides a standard index to measure the value of things so that we may exchange dissimilar assets. But as useful as it is, money cannot fix in any way the abstract potential

of a particular asset in order to convert it into capital. Third World and former communist nations are infamous for inflating their economies with money while not being able to generate much capital.

The Potential Energy in Assets

What is it that fixes the potential of an asset so that it can put additional production into motion? What detaches value from a simple house and fixes it in a way that allows us to realize it as capital?

We can begin to find an answer by using our energy analogy. Consider a mountain lake. We can think about this lake in its immediate physical context and see some primary uses for it, such as canoeing and fishing. But when we think about this same lake as an engineer would by focusing on its capacity to generate energy as an additional value beyond the lake's natural state as a body of water, we suddenly see the potential created by the lake's elevated position. The challenge for the engineer is finding out how he can create a *process* that allows him to convert and fix this potential into a form that can be used to do additional work. In the case of the elevated lake that process is contained in a hydroelectric plant that allows the lake water to move rapidly downward with the force of gravity, thereby transforming the placid lake's energy potential into the kinetic energy of tumbling water. This new kinetic energy may then rotate turbines, creating mechanical energy that may be used to turn electromagnets that further convert it into electrical energy. As electricity, the potential energy of the placid lake is now fixed

in the form necessary to produce controllable current that may be further transmitted through wire conductors to far-away places to deploy new production.

Thus an apparently placid lake may be used to illuminate your room and power the machinery in a factory. What was required was an external man-made process, which allowed us, first, to identify the potential of the weight of the water to do additional work; and, second, to convert this potential energy into electricity that may be used to create surplus value. The additional value we obtain from the lake is not a value of the lake itself (like a precious ore intrinsic to the earth), but rather a value of the man-made process *extrinsic* to the lake. It is this process that allows us to transform the lake from a fishing and canoeing kind of place into an energy-producing kind of place.

Capital, like energy, is also a dormant value. Bringing it to life requires us to go beyond *looking* at our assets as they are to *thinking* actively about them as they could be. It requires a process for fixing an asset's economic potential into a form that may be used to initiate additional production.

Yet, while the process that converts the potential energy in the water into electricity is well known, the one that gives assets the form required to put in motion more production is not known. In other words, while we know that it is the penstock, turbines, generators, transformers and wires of the hydroelectric energy system that convert the potential energy of the lake until it is fixed in an accessible form, we do not know where to find the key process that converts the economic potential of a house into capital.

This is because that key process was not deliberately set up to create capital, but for the more mundane purpose of

protecting property ownership. As the property systems of Western nations grew, they developed, imperceptibly, a variety of mechanisms that gradually combined into a process that churned out capital as never before. Although we use these mechanisms all the time, we do not realize that they have capital-generating functions because they do not wear that label. We view them as parts of the system that protects property, not as interlocking mechanisms for fixing the economic potential of an asset in such a way that it can be converted into capital. What creates capital in the West, in other words, is an implicit process buried in the intricacies of its formal property systems.

The Hidden Conversion Process of the West

This may sound too simple or too complex. But consider whether it is possible for assets to be used productively if they do not belong to something or someone. Where do we confirm the existence of these assets and the transactions that transform them and raise their productivity if not in the context of a formal property system? Where do we record the relevant economic features of assets if not in the records and titles that formal property systems provide? Where are the codes of conduct that govern the use and transfer of assets if not in the framework of formal property systems? It is formal property that provides the process, the forms and the rules that fix assets in a condition that allows us to realize them as active capital.

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 capital's hydroelectric plant. This is the place where capital is born.

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 truly 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 saw in the previous chapter, these countries' principal problem is not the lack of entrepreneurship: the poor have accumulated trillions of dollars of real estate during the last 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. In the West every asset – every piece of land, every house, every chattel – is formally fixed in 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'.

Like electric power, capital will not be generated if the single key facility that produces and fixes it is not in place. Just as a lake needs a hydroelectric plant to produce usable energy, assets need a formal property system to produce significant surplus value. Without formal property to extract their economic potential and convert it into a form that can be easily transported and controlled, the assets of developing and former communist countries are like water in a lake high in the Andes – an untapped stock of potential energy.

Why has the genesis of capital become such a mystery? Why have the rich nations of the world, so quick with their economic advice, not explained how indispensable formal property is to capital formation? The answer is that the process within the formal property system that breaks down assets into capital is extremely difficult to visualize. It is hidden in thousands of pieces of legislation, statutes,

regulations and institutions that govern the system. Anyone trapped in such a legal morass would be hard pressed to figure out how the process works. The only way to see it is from outside the system – from the extralegal sector – which is where my colleagues and I do most of our work.

For some time now I have been looking at the law from an extralegal point of view, to understand better how it functions and what effects it produces. This is not as crazy as it seems. As the French philosopher Michel Foucault has argued, it may be easier to discover what something means by looking at it from the opposite side of the bridge. 'To find out what our society means by sanity', Foucault has written, 'perhaps we should investigate what is happening in the field of insanity. And what we mean by legality in the field of illegality.'⁸ Moreover, property, like energy, is a concept; it cannot be experienced directly. Pure energy has never been seen or touched. And no one can see property. One can only experience energy and property by their effects.

From my viewpoint in the extralegal sector, I have seen that the formal property systems of the West produce six effects that allow their citizens to generate capital. The incapacity elsewhere in the world to deploy capital stems from the fact that most of the people in Third World and former communist countries are cut off from these essential effects.

Property Effect No. 1: Fixing the Economic Potential of Assets

The potential value locked up in a house can be revealed and transformed into active capital in the same way that potential

energy is identified in a mountain lake and then transformed into actual energy. In both cases the transition from one state to another requires a process that transposes the physical object into a man-made representative universe where we can disengage the resource from its burdensome material constraints and concentrate on its potential.

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, as opposed to the visually more striking aspects *of* the asset. This is where potential value is first described and registered. The moment you focus your attention on the title of a house, for example, and not on the house itself, you have automatically stepped from the material world into the conceptual universe where capital lives. You are reading a representation that focuses your attention on the economic potential of the house by filtering out all the confusing lights and shadows of its physical aspects and its local surroundings. Formal property forces you to think about the house as an economic and social concept. It invites you to go beyond viewing the house as mere shelter – and thus a dead asset – and to see it as live capital.

The proof that property is pure concept comes when a house changes hands; nothing physically changes. Looking at a house will not tell you who owns it. A house that is yours today looks exactly as it did yesterday when it was mine. It looks the same whether I own it, rent it or sell it to you. Property is not the house itself but an economic concept *about* the house, embodied in a legal representation. This means that a formal property representation is something separate from the asset itself.

What do formal property representations have that allows them to do additional work? Are they not just simple stand-ins for the assets? No. I repeat: a formal property representation such as a title is not a reproduction *of* the house, like a photograph, but a representation *of* our concepts *about* the house. Specifically, it represents the non-visible qualities that have potential for producing value. These are not physical qualities of the house itself but rather economically and socially meaningful qualities we humans have attributed to the house (such as the ability to use it for a variety of purposes that may be secured by liens, mortgages, easements and other covenants).

In advanced nations this formal property representation functions as the means to secure the interests of other parties, and to create accountability by providing all the information, references, rules and enforcement mechanisms required to do so. In the West, for example, most formal property can be easily used as collateral for a loan; as equity exchanged for investment; as an address for collecting debts, rates and taxes; as a locus point for the identification of individuals for commercial, judicial or civic purposes; or as a liable terminal for receiving public utility services, such as energy, water, sewage, telephone or TV. While houses in advanced nations are acting as shelters or workplaces, their representations are leading a parallel life, carrying out a variety of additional functions to secure the interests of other parties.

Legal property thus gave the West the tools to produce surplus value over and above its physical assets. Property representations enabled people to think about assets not only through physical acquaintance but through the description of their latent economic and social qualities. Whether anyone

intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital, where assets can be viewed in their full productive potential.

With legal property, the advanced nations of the West had the key to modern development; their citizens now had the means to discover, with great facility and on an ongoing basis, the most potentially productive qualities of their resources. As Aristotle discovered 2,300 years ago, what you can do with things increases infinitely when you focus your thinking on their potential. By learning to fix the economic potential of their assets through property records, Westerners created a fast track to explore the most productive aspects of their possessions. Formal property became the staircase to the conceptual realm where the economic meaning of things can be discovered and where capital is born.

Property Effect No. 2: Integrating Dispersed Information into One System

As we saw in the previous chapter, most people in developing and former communist nations cannot enter the legal property system, such as it is, no matter how hard they try. Because they cannot insert their assets into the legal property system, they end up holding them extralegally. The reason capitalism has triumphed in the West and faltered in the rest of the world is because most of the assets in Western nations have been integrated into one formal representational system.

This integration did not happen casually. Over decades in the nineteenth century, politicians, legislators and judges pulled together the scattered facts and rules that had

governed property throughout cities, villages, buildings and farms and integrated them into one system. This 'pulling together' of property representations, a revolutionary moment in the history of developed nations, deposited all the information and rules governing the accumulated wealth of their citizens into one knowledge base. Before that moment, information about assets was far less accessible. Every farm or settlement recorded its assets and the rules governing them in rudimentary ledgers, symbols or oral testimony. But the information was atomized, dispersed and not available to any one agent at any given moment. As we know too well today, an abundance of facts is not necessarily an abundance of knowledge. For knowledge to be functional, advanced nations had to integrate into one comprehensive system all their loose and isolated data about property.

Developing and former communist nations have not done this. In all the countries I have studied I have never found just one legal system but dozens or even hundreds, managed by all sorts of organizations, some legal, others extralegal, ranging from small entrepreneurial groups to housing organizations. 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, where property information is standardized and universally available, what owners can do with their assets benefits from the collective imagination of a larger network of people.

It may surprise the Western reader that most of the world's nations have yet to integrate extralegal property agreements into one formal legal system. For Westerners, there supposedly is only one law – the official one. Yet the West's reliance on integrated property systems is a phenomenon at most of

the last two hundred years. In most Western countries integrated property systems appeared only about a hundred years ago; Japan's integration happened little more than fifty years ago. As we shall see in detail later, diverse informal property arrangements were once the norm in every nation. Legal pluralism was the standard in continental Europe until Roman law was rediscovered in the fourteenth century and governments assembled all currents of law into one coordinated system.

In California just after the gold rush of 1849 there were some eight hundred separate property jurisdictions, each with its own records and individual regulations established by local consensus. Throughout the United States, from California to Florida, claim associations agreed on their own rules and elected their own officers. It took more than one hundred years, well into the late nineteenth century, for the US government to pass special statutes that integrated and formalized US assets. By enacting more than thirty-five pre-emption and mining statutes, Congress gradually managed to integrate into one system the informal property rules created by millions of immigrants and squatters. The result was an integrated property market that fuelled the United States' explosive economic growth thereafter.

The reason why it is so hard to follow this history of the integration of widespread property systems is that the process took place over a very long time. Formal property registries began to appear in Germany, for example, in the twelfth century, but were not fully integrated until 1896, when the *Grundbuch* system for recording land transactions began operating on a national scale. In Japan the national campaign to formalize the property of farmers began in the late

nineteenth century and ended only in the late 1940s. Switzerland's extraordinary efforts to bring together the disparate systems that protected property and transactions at the turn of the twentieth century are still not well known, even to many Swiss.

As a result of integration, citizens in advanced nations can obtain descriptions of the economic and social qualities of any available asset without having to see the asset itself. They no longer need to travel around the country to visit each and every owner and their neighbours; the formal property system lets them know what assets are available and what opportunities exist to create surplus value. Consequently, an asset's potential has become easier to evaluate and exchange, enhancing the production of capital.

Property Effect No. 3: Making People Accountable

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.

By transforming people with property interests into accountable individuals, formal property created individuals from masses. People no longer needed to rely on neighbourhood relationships or to make local arrangements to protect their rights to assets. Freed from primitive economic activities and burdensome parochial constraints, they could explore how to generate surplus value from their own assets. But there was a price to pay: once inside a formal property system

owners lost their anonymity. By becoming inextricably linked to real estate and businesses that could be easily identified and located, people forfeited the ability to lose themselves in the masses. The anonymity option has practically disappeared in the West, while individual accountability has been reinforced. People who do not pay for goods or services they have consumed can be identified, charged interest penalties, fined, embargoed and have their credit ratings downgraded. Authorities are able to learn about legal infractions and dishonoured contracts; they can suspend services, place liens against property and withdraw some or all of the privileges of legal property.

Respect in Western nations for property and transactions is hardly encoded in their citizens' DNA; it is rather the result of having enforceable formal property systems. Formal property's role in protecting not only ownership but the security of transactions encourages citizens in advanced countries to respect titles, honour contracts and obey the law. When any citizen fails to act honourably, his breach is recorded in the system, jeopardizing his reputation as a trustworthy party to his neighbours, utilities, banks, telephone companies, insurance firms and the rest of the network to which property ties him.

Thus the formal property systems of the West have bestowed mixed blessings. While they provided hundreds of millions of citizens with a stake in the capitalist game, what made this stake meaningful was that it could be lost. A great 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, from the constraints it imposes, the rules it spawns and the sanctions it

can apply. By allowing people to see the economic and social potential of assets, formal property changed the perception in advanced societies of not only the potential rewards of using assets but the dangers of doing so. Legal property invited commitment.

The lack of legal property thus explains why citizens in developing and former communist nations cannot make profitable contracts with strangers, cannot get credit, insurance or utilities services: they have no property to lose. Because they have no property to lose, they are taken seriously as contracting parties only by their immediate family and neighbours. People with nothing to lose are trapped in the grubby basement of the pre-capitalist world.

Meanwhile, citizens of advanced nations can contract for practically anything that is reasonable, but the entry price is commitment. And commitment is better understood when backed up by a pledge of property, whether it be a mortgage, a lien or any other form of security that protects the other contracting party.

Property Effect No. 4: Making Assets Fungible

One of the most important things a formal property system does is transform assets from a less to a more accessible condition, so that they can do additional work. Unlike physical assets, representations are 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 practically any transaction.

By describing all assets in standard categories, an

integrated formal property system makes possible the comparison of two architecturally different buildings constructed for the same purpose. This allows one to discriminate quickly and inexpensively between similarities and differences in assets without having to deal with each asset as if it were unique.

Standard property descriptions in the West are also written to 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. Through the use of standardized records, one can determine (on the basis of zoning restrictions, who the neighbours are and what they are doing, the square footage of the buildings, whether they can be joined, etc.) how to exploit a particular piece of real estate most profitably, whether as office space, for hotel rooms, a bookshop or squash courts and a sauna.

Representations also enable the division of assets without touching them. While an asset such as a factory may be an indivisible unit in the real world, in the conceptual universe of formal property representation it can be subdivided into any number of portions. 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.

Similarly, in a developed country, the farmer's son who wishes to follow in his father's footsteps can keep the farm by

buying out his more commercially minded siblings. Farmers in many developing countries have no such option and must continually subdivide their farms for each generation until the parcels are too small to farm profitably, leaving the descendants with two alternatives: starving or stealing.

Formal property representations can also serve as movable stand-ins for physical assets, enabling owners and entrepreneurs to simulate hypothetical situations in order to explore other profitable uses of their assets – much as military officers plan their strategy for a battle by moving symbols of their troops and weapons around a map. If you think about it, it is property representations that allow entrepreneurs to simulate business strategies to grow their companies and build capital.

In addition, all standard formal property documents are crafted in such a way as to facilitate the easy measurement of an asset's attributes. If standard descriptions of assets were not readily available, anyone who wanted to buy, rent or give credit against an asset would have to expend enormous resources comparing and evaluating it against other assets – which also would lack standard descriptions. By providing standards, Western formal property systems have significantly reduced the transaction costs of mobilizing and using assets.

Once assets are in a formal property system, they endow their owners with an enormous advantage in that they can be divided and combined in more ways than a Meccano set. Westerners may adapt their assets to any economic circumstance to produce continually higher valued mixtures, while their Third World counterparts remain trapped in the physical world of rigid, non-fungible forms.

Property Effect No. 5: Networking People

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 accessible, formal property systems converted the citizens of the West into a network of individually identifiable and accountable business agents. The formal property process created a whole infrastructure of connecting devices that, like a railway switchyard, allowed the assets (trains) to run safely between people (stations). Formal property's contribution to mankind is not the protection of ownership; squatters, housing organizations, mafias and even primitive tribes manage to protect their assets quite efficiently. Property's real breakthrough is that it radically improved the flow of communications about assets and their potential. It also enhanced the status of their owners, who became economic agents able to transform assets within a broader network.

This explains how legal property encourages the suppliers of such utilities as electricity and water to invest in production and distribution facilities to service buildings. By legally attaching the buildings where the services will be delivered to their owners, who will be using and paying for the services, a formal property system reduces the risk of theft of services. It also reduces the financial losses from bill-collecting among people hard to locate, as well as technical losses from incorrectly estimating the electricity needs of areas where businesses and residents are clandestine and not recorded. Without knowing who has the rights to what, and

without an integrated legal system where the ability to enforce obligations has been transferred from extralegal groups to government, utilities would be hard pressed to deliver services profitably. On what other basis could they identify subscribers, create utility subscription contracts, establish service connections and ensure access to parcels and buildings? How would they implement billing systems, meter-reading, collection mechanisms, loss control, fraud control, delinquent charging procedures and enforcement services such as meter shut-offs?

Buildings are always the terminals of public utilities. What transforms them into *accountable* and *responsible* terminals is legal property. Anyone who doubts this need only look at the utility situation outside the West, where technical and financial losses plus theft of services account for 30 to 50 per cent of all available utilities.

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.

Few seem to have noticed that the legal property system of an advanced nation is the centre of a complex web of connections that equips ordinary citizens to form ties with both the government and the private sector, and so to obtain additional goods and services. Without the tools of formal property, it is hard to see how assets could be used for everything they accomplish in the West. How else could financial organizations identify trustworthy potential

borrowers on a massive scale? How could physical objects, like timber in Oregon, secure an industrial investment in Chicago? How could insurance companies find and contract customers who will pay their bills? How could information brokerage or inspection and verification services be provided efficiently and cheaply? How could tax collection work?

It is the property system that draws out the abstract potential from buildings and fixes it in representations that allow us to go beyond passively using the buildings only as shelters. Many title systems in developing nations fail to produce capital because they do not acknowledge that property can go way beyond ownership. These systems function purely as an ownership inventory of deeds and maps standing in for assets, without allowing for the additional mechanisms required to create a network where assets can lead a parallel life as capital. Formal property should not be confused with such massive inventory systems as the English Domesday Book of nine hundred years ago or a luggage check operation in an international airport. Properly understood and designed, a property system creates a network through which people can assemble their assets into more valuable combinations.

Property Effect No. 6: Protecting Transactions

One important reason why the Western formal property system works like a network is that all the property records (titles, deeds, securities and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Their first stop is the public agencies that are the stewards of

an advanced nation's representations. Public record-keepers administer the files that contain all the economically useful descriptions of assets, whether land, buildings, chattels, ships, industries, mines or aeroplanes. These files will alert anyone eager to use an asset about things that may restrict or enhance its realization, such as encumbrances, easements, leases, arrears, bankruptcies and mortgages. The agencies also ensure that assets are adequately and accurately represented in appropriate formats that can be updated and easily accessed.

In addition to public record-keeping systems many other private services have evolved to assist parties in fixing, moving and tracking representations so that they can easily and securely produce surplus value. These include private entities that record transactions, escrow and closings organizations, abstractors, appraisers, title and fidelity insurance firms, mortgage brokers, trust services and private custodians of documents. In the United States title insurance companies further help the mobilization of representations by issuing policies to cover parties for specified risks, ranging from defects on titles to unenforceability on mortgages and unmarketability of title. By law, all these entities have to follow strict operating standards that govern their document-tracking capabilities, physical storage facilities and staffing.

Although they are established to protect both the security of ownership and that of transactions, it is obvious that Western systems emphasize the latter. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital.

In most developing countries, by contrast, the law and official agencies are trapped by early colonial and Roman law,

which tilt towards protecting ownership. They have become custodians of the wishes of the dead. This may explain why the creation of capital in Western property happens so easily, and why most of the assets in developing and ex-communist countries have slipped out of the formal legal system in search of mobility.

The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. How else can we explain that in developing and former communist nations people are still taking their pigs to market and trading them one at a time, as they have done for thousands of years, while in the West traders take representations of their rights over pigs to the market? Traders at the Chicago commodities exchange, for example, deal through representations, which give them more information about the pigs they are trading than if they could physically examine each pig. They are able to make deals for huge quantities of pigs with little concern about the security of transactions.

Capital and Money

The six effects of an integrated property process mean that Westerners' houses no longer merely keep the rain and cold out. Endowed with representational existence, these houses can now lead a parallel life, doing *economic* things they could not have done before. A well-integrated legal property system in essence does two things: first, it tremendously reduces the costs of knowing the economic qualities of assets by representing them in a way that our senses can pick up quickly; and, second, it facilitates the capacity to agree on

how to use assets to create further production and increase the division of labour. The genius of the West was to have created a system that allowed people to grasp with the mind values that human eyes could never see and to manipulate things that hands could never touch.

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. Property seeds the system by making people accountable and assets fungible, by tracking transactions, and so providing all the mechanisms required for the monetary and banking system to work and for investment to function. The connection between capital and modern money runs through property.

Today it is documented information that can ultimately be traced back to legal records of property ownership and transactions that provide monetary authorities with the indicators they need to issue legal tender. As cognitive scientists George A. Miller and Philip N. Johnson-Laird wrote in 1976: 'Paper currency owes its origins to the writing of debt notes. [Therefore,] money . . . presupposes the institution of property.'⁹ It is property documentation that fixes the economic characteristics of assets so that they can be used to secure commercial and financial transactions, and ultimately

provides the justification against which central banks issue money. To create credit and generate investment, what people encumber are not the physical assets themselves, but their property representations – the recorded titles or shares – governed by rules that can be enforced nationwide. Money does not earn money. You need a property right before you can make money. Even if you loan money, the only way you can earn on it is by loaning or investing it against some kind of property document that establishes your rights to principal and interests. To repeat: money presupposes property.

As the eminent German economists Gunnar Heinsohn and Otto Steiger point out, 'Money is *never created ex nihilo* from the point of view of property, which must always exist before money can come into existence.'¹⁰ Recognizing similarities between their work and mine, they brought to my attention an unpublished draft of an article stating 'that interest and money cannot be understood without the institution of property'.¹¹ This relationship is obscured, they maintain, by the common misapprehension that central banks issue notes and support the ability of commercial banks to make payments. In Heinsohn and Steiger's view, what escapes the naked eye is 'that all advances are made in good banking against securities',¹² or, in my terms, legal property paper. They agree with Harold Demsetz that the property rights foundation of capitalism has been taken for granted, and note that Joseph Schumpeter already had an inkling that it is property rights that secure the creation of money. As Tom Bethell correctly states in his extraordinary book *The Noblest Triumph*: 'the many blessings of a private property system have never been properly analyzed'.¹³

Capital, as I argued earlier, is therefore not created by

money; it is created by people whose property systems help them to cooperate and think about how they can get the assets they accumulate to deploy additional production. The substantial increase of capital in the West over the last two centuries is the consequence of gradually improving property systems, which allowed economic agents to discover and realize the potential in their assets, and thus to be in a position to produce the non-inflationary money with which to finance and generate additional production.

So, we are more than squirrels who store food for winter and engage in deferred consumption. We know, through the sophisticated use of property institutions, how to give the things we accumulate a parallel life. When advanced nations pulled together all the information and rules about their known assets and established property systems that tracked their economic evolution, they gathered into one order the whole institutional process that underpins the creation of capital. If capitalism had a mind, it would be located in the legal property system. But, like most things pertaining to the mind, much of 'capitalism' today operates at a subconscious level.

Why did the classical economists, who knew capital was abstract and had to be fixed, not make the connection between capital and property? One explanation may be that in Adam Smith's or even Marx's day property systems were still restricted and undeveloped and their importance was difficult to gauge. Perhaps more significantly, the battle for the future of capitalism shifted from the book-lined studies of theoreticians into a vast web of entrepreneurs, financiers, politicians and jurists. The attention of the world turned from theories to the real deals being made on the ground, day by day, fiscal year after fiscal year.

Once the vast machine of capitalism was firmly in place and its masters were busy creating wealth, the question of how it all came into being lost its urgency. Like people living in the rich and fertile delta of a long river, the advocates of capitalism had no pressing need to explore upstream for the source of their prosperity. Why bother? With the end of the Cold War, however, capitalism became the only serious option for development. So the rest of the world turned to the West for help and was advised to imitate the conditions of life on the delta: stable currencies, open markets and private businesses, the objectives of so-called 'macroeconomic and structural adjustment reforms'. Everyone forgot that the reason for the delta's rich life lay far upriver, in its unexplored headwaters. Widely accessible legal property systems are the silt from upriver that permits modern capital to flourish.

This is one of the principal reasons why macroeconomic reforms are not working. Imitating capitalism at the level of the delta, by importing McDonald's and Blockbuster franchises, is not enough to create wealth. Capital is needed, and this requires a complex and mighty system of legal property that we have all taken for granted.

Braudel's Bell Jar

Much of the marginalization of the poor in developing and former communist nations comes from their inability to benefit from the six effects that property provides. The challenge these countries face is not whether they should produce or receive more money but whether they can understand the legal institutions and summon the political

will necessary to build a property system that is easily accessible to the poor.

The French historian Fernand Braudel found it a great mystery that, at its inception, Western capitalism served only a privileged few, just as it does elsewhere in the world today:

The key problem is to find out why that sector of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? ... [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole market economy of the time? ... It would perhaps be teasingly paradoxical to say that whatever else was in short supply, money certainly was not ... so this was an age where poor land was bought up and magnificent country residences built, great monuments erected and cultural extravagance financed ... [How do we] resolve the contradiction ... between the depressed economic climate and the splendors of Florence under Lorenzo the Magnificent?¹⁴

I believe the answer to Braudel's question lies in restricted access to formal property, both in the West's past and in developing and former communist countries today. Local and foreign investors do have capital; their assets are more or less integrated, fungible, networked and protected by formal property systems. But they are only a tiny minority – those who can afford the expert lawyers, insider connections and patience required to navigate the red tape of their property systems. The great majority of people, who cannot get the

fruits of their labour represented by the formal property system, live outside Braudel's bell jar.

The bell jar makes capitalism a private club, open only to a privileged few, and enrages the billions standing outside looking in. This capitalist apartheid will inevitably continue until we all come to terms with the critical flaw in many countries' legal and political systems that prevents the majority from entering the formal property system.

The time is right to discover why most countries have not been able to create open formal property systems. This is the moment, as Third World and ex-communist nations are living through their most ambitious attempts to implement capitalist systems, to lift the bell jar.

But before we answer that question, we have to solve the rest of the mystery of why governments have been so slow to realize that a bell jar exists.

4

THE MYSTERY OF POLITICAL AWARENESS

*Hark, hark! the dogs do bark,
The beggars are coming to town;
Some in rags and some in jags,
And some in silken gown.
English nursery rhyme*

The breakdown of population patterns and mandatory law has been an unmistakable trend in developing countries for the past forty years and in ex-communist countries for the past ten. Since Deng Xiaoping's economic reforms began in 1979, 100 million Chinese have left their official homes in search of extralegal jobs. Three million illegal migrants besieging Beijing have created a jumble of sweatshops on the outskirts of the city. Port-au-Prince has grown fifteen times larger; Guayaquil eleven times larger; and Cairo four times larger. The underground market now accounts for 50 per cent of GDP in Russia and Ukraine and a whopping 62 per cent in Georgia. The International Labour Organization reports that since 1990 85 per cent of all new jobs in Latin America and the Caribbean have been created in the

extralegal sector. In Zambia, only 10 per cent of the workforce is legally employed.

What are these countries doing about this? Quite a lot. They have rolled up their sleeves and gone to work, addressing each of these problems individually. In August 1999, for example, Bangladeshi authorities demolished fifty thousand shanties in the capital city of Dhaka. Where demolition is impossible, governments have built schools and pavements for the millions of squatters invading public and private lands. At the same time governments have supported micro-finance programmes to assist the sweatshops that are transforming residential areas into industrial zones throughout the world. They have improved the stalls of pavement vendors clogging their streets; removed hordes of drifters from their city squares and planted flowers instead; tightened construction and safety codes to prevent buildings collapsing as they did in Turkey during the 1999 earthquake. Governments have tried to force the independent jitneys and shabby taxis that glut traffic to meet minimum safety standards; they are cracking down on theft and loss of water and electricity and trying to enforce patents and copyrights. They have arrested and executed as many gangsters and drug traffickers as possible (at least the more famous ones) and jailed them (at least for a while); they have tightened security measures to control the influence of extreme political sects among the uprooted and vulnerable multitudes.

Each of these problems has its own academic speciality to study it and its own political programme to cope with it. Few seem to realize that what we have here is *one* huge, world-wide industrial revolution: a gigantic movement away from life organized on a small scale to life organized on a large

one. For better or for worse, people outside the West are fleeing self-sufficient and isolated societies in an effort to raise their standards of living by becoming interdependent in much larger markets.

It is understood all too rarely that the Third World and former communist societies are experiencing nearly the same industrial revolution that arrived in the West more than two centuries ago. The difference is that this new revolution is roaring ahead much faster and transforming the lives of many more people. Britain supported just 8 million people when it began its 250-year progression from the farm to the laptop computer. Indonesia is making that same journey in only four decades and carrying a population of more than 200 million. No wonder its institutions have been slow to adapt. But adapt they must. A tide of humanity has moved from isolated communities and households to participate in ever-widening circles of economic and intellectual exchange. It is this tide that has transformed Jakarta, Mexico City, São Paulo, Nairobi, Bombay, Shanghai and Manila into megacities of 10, 20, 30 million and overwhelmed their political and legal institutions.

The failure of the legal order to keep pace with this astonishing economic and social upheaval has forced the new migrants to invent extralegal substitutes for established law. Whereas all manner of anonymous business transactions are widespread in advanced countries, the migrants in the developing world can deal only with people they know and trust. Such informal, *ad hoc* business arrangements do not work very well. The wider the market, as Adam Smith pointed out, the more minute the division of labour can be. And as labour grows more specialized, the economy grows

6

THE MYSTERY OF LEGAL FAILURE

Why Property Law Does Not Work Outside the West

The life of the law has not been logic; it has been experience.

US SUPREME COURT JUSTICE OLIVER WENDELL HOLMES

Nearly every developing and ex-communist nation has a formal property system. The problem is that most of their citizens cannot gain access to it. They have run into Fernand Braudel's bell jar, that invisible structure in the past of the West that reserved capitalism for a very small sector of society. Their only alternative, as we saw in Chapter 2, is to retreat with their assets into the extralegal sector where they can live and do business – but without ever being able to convert their assets into capital.

Before we can lift the bell jar, it is important to know that we will not be the first to try. As we shall see in this chapter, governments in developing countries have tried for 180 years to open up their property systems to the poor.

Why have they failed? The reason is that they usually

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operate under five basic misconceptions:

- Δ all people who take cover in the extralegal or underground sectors do so to avoid paying taxes;
- Δ real estate assets are not held legally because they have not been properly surveyed, mapped and recorded;
- Δ enacting mandatory law on property is sufficient, and governments can ignore the costs of compliance with that law;
- Δ existing extralegal arrangements or 'social contracts' can be ignored;
- Δ you can change something as fundamental as people's conventions on how they can hold their assets, both legal and extralegal, without high-level political leadership.

To explain these countries' underground economies, in which 50 to 80 per cent of the people typically operate, in terms of tax evasion is partially incorrect at best. Most people do not resort to the extralegal sector because it is a tax haven but because existing law, however elegantly written, does not address their needs or aspirations. In Peru, where my team designed the program for bringing small extralegal entrepreneurs into the legal system, some 276,000 of those entrepreneurs recorded their businesses *voluntarily* in new registry offices we set up to accommodate them – with no promise of tax reductions. Their underground businesses had paid no taxes at all. Four years later tax revenues from formerly extralegal businesses totalled US\$1.2 billion.

We were so successful because we modified company and property law to adapt to the needs of entrepreneurs

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accustomed to extralegal rules. We also cut dramatically the costs of the red tape to enrol businesses. This is not to say that people do not care about their tax bill. But extralegal manufacturers and shopkeepers – who operate on razor-thin profit margins, in cents rather than dollars – know basic arithmetic. All we had to do was make sure the costs of operating legally were below those of surviving in the extralegal sector, facilitate the paperwork for legalization, make a strong effort to communicate the advantages of the programme, and then watch hundreds of thousands of entrepreneurs happily quit the underground.

Contrary to popular wisdom, operating in the underground is hardly cost-free. Extralegal businesses are taxed by the lack of good property law and continually having to hide their operations from the authorities. Because they are not incorporated, extralegal entrepreneurs cannot lure investors by selling shares; 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 extralegal entrepreneurs live in constant fear of government detection and extortion from corrupt officials, they are forced to split and compartmentalize their production facilities between many locations, thereby rarely achieving important economies of scale. In Peru 15 per cent of gross income from manufacturing in the extralegal sector is paid out in bribes, ranging from 'free samples' and special 'gifts' of merchandise to outright cash. With one eye always on the lookout for the police, underground entrepreneurs

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cannot openly advertise to build up their clientele or make less costly bulk deliveries to customers.

Our research has confirmed that in most countries being free from the costs and nuisance of the extralegal sector generally compensates for paying taxes. Whether you are inside the bell jar or outside, you will be taxed. What determines whether you remain outside is the relative cost of being legal.

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. This, too, is at best partially true. Europeans and Americans managed to record all their real estate assets decades before computers and geographical information systems were invented. As we saw in the last chapter, throughout the nineteenth century the surveying of newly settled land in the United States lagged many years behind the conveyance of property rights. In Japan I examined the documentation available in registry offices and saw how some land assets had been recorded after the Second World War using maps from the Edo period – three to four centuries before the invention of aerial photography and global positioning systems.

This does not mean that state-of-the-art computing and geographical information systems are not extremely important to any government's efforts to open up its property system to the poor. What it does mean is that the widespread undercapitalization, informal squatting and illegal housing throughout the non-Western world are hardly caused by a lack of advanced information and mapping technology.

Braudel's bell jar is made not of taxes, maps and computers

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but laws. 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. Inside the bell jar are élites who hold property using codified law borrowed from the West. Outside the bell jar, where most people live, property is used and protected by all sorts of extralegal arrangements firmly rooted in informal consensus dispersed through large areas. These local social contracts represent collective understandings 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 – the beliefs, desires, intentions, customs and rules – 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.

The crucial point to understand is that property is not a physical thing that can be photographed or mapped. Property is not a primary quality of assets, but the legal expression of an economically meaningful consensus *about* assets. Law is the instrument that fixes and realizes capital. In the West the law is less concerned with representing the physical reality of buildings or real estate than with providing a process or rules that will allow society to extract potential surplus value from those assets. Property is not the assets themselves but a consensus between people as to how those 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 buildings into the same map (which has probably already been done) but to integrate the formal legal conventions inside the bell jar with the extralegal ones outside it.

No amount of surveying and mapping will accomplish this. No amount of computerizing will convert assets into a form that allows them to enter expanded markets and become capital. As we saw in Chapter 3, assets themselves have no effect on social behaviour: they do not produce incentives, they make no person accountable, no contract enforceable. Assets are not intrinsically 'fungible' – capable of being divided, combined or mobilized to suit any transaction. All of these qualities grow out of modern property law. It is law that detaches and fixes the economic potential of assets as a value separate from the material assets themselves and allows humans to discover and realize that potential. It is law that connects assets into financial and investment circuits. And it is the representation of assets fixed in legal property documents that gives them the powers to create surplus value.

More than sixty years ago, the eminent legal historian C. Reinold Noyes wrote:

The chips in the economic game today are not so much the physical goods and actual services that are almost exclusively considered in economic text books, as they are that elaboration of legal relations which we call property . . . One is led, by studying its development, to conceive the social reality as a web of intangible bonds – a cobweb of invisible filaments – which surround and engage the individual and which thereby *organize* society . . . And the process of coming to grips with the actual world we live in is the process of objectivizing these relations.¹

Lifting the bell jar, then, is principally a legal challenge.

The official legal order must interact with extralegal arrangements outside the bell jar to create a social contract on property and capital. To achieve this integration, many other disciplines are, of course, necessary: economists have to get the costs and numbers right; urban planners and agronomists must assign priorities; mappers, surveyors and computer experts are indispensable to make the information systems work. But, ultimately, an integrated, national social contract will be concretized only in laws. All other disciplines play only a supporting role.

Does that mean that lawyers should lead the integration process? No. Implementing major legal change is a political responsibility. There are various reasons for this. First, law is generally concerned with protecting property rights, but the real task in developing and ex-communist countries is not so much to perfect existing rights as to give everyone a right to property rights – 'meta-rights', if you will. Bestowing such meta-rights, emancipating people from bad law, is a political job. Second, very small, but powerful, vested interests – mostly represented by the countries' best commercial lawyers – are likely to oppose change unless they are convinced otherwise. Bringing well-connected and moneyed people on to the bandwagon requires not consultants committed to serving their clients but talented politicians committed to serving their people. Third, 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 real people is a politician's task. Fourth, prodding underground economies to become legal is a major political sales job. Governments must convince poorer citizens – who

mistrust government and survive on tight parochial arrangements – and some of the mafias who protect them to buy an entry ticket into a much bigger and looser game. Governments must also convince influential leftists, who in many countries are close to the grassroots, that enabling their constituencies to produce capital is the best way to help them. Citizens inside and outside the bell jar need government to make a strong case that a redesigned, integrated property system is less costly, more efficient and better for the nation than the existing anarchical arrangements.

Without succeeding on these legal and political fronts, no nation can overcome the legal apartheid between those who can create capital and those who cannot. Without formal property, no matter how many assets they accumulate or how hard they work, most people will not be able to prosper in a capitalist society. They will continue to remain beyond the radar of policy-makers, out of the reach of official records, and thus economically invisible.

Western governments succeeded in lifting the bell jar, but it was an erratic, unconscious process that took hundreds of years. My colleagues and I have synthesized what we think they did right into a formula we call the 'capitalization process', with which we are assisting various governments throughout the world (see Figure 6.1). Explaining the details is not part of this book, but readers who would like a technical description of the entire plan are invited to consult unpublished documentation in Institute for Liberation and Democracy archives. In the rest of this chapter I will focus on the two indispensable components of the formula: the legal challenge (A.4 in Figure 6.1) and the political challenge (B.1 in Figure 6.1).

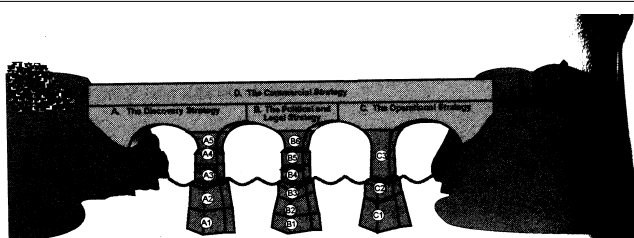


Figure 6.1
CAPITALIZATION PROCESS
MOVEMENT FROM DEAD CAPITAL TO LIVE CAPITAL

A. THE DISCOVERY STRATEGY

A.1 Identify, locate and classify extralegal assets (dead capital)

- A.1.1 Develop local recruitment specifications to penetrate extralegal sector.
- A.1.2 Determine causes for the accumulation of extralegal assets so as to develop workable typologies.
- A.1.3 Locate economic sectors and geographic areas where extralegal activities are most prevalent.
- A.2 **Quantify the actual and potential value of extralegal assets (dead capital)**
- A.2.1 Develop appropriate methodologies to estimate the value of extralegal assets using existing information and data gathered in the field.
- A.2.2 Customize criteria to gather and process information and to confirm results.
- A.2.3 Establish the importance of the value of extralegal assets.
- A.3 **Analyze the interaction of the extralegal sector with the rest of society**
- A.3.1 Research the relevant links between government and extralegal assets.
- A.3.2 Research the relevant links between legal businesses and extralegal assets.
- A.3.3 Identify processes where government has already successfully dealt with extralegal assets.
- A.4 **Identify the extralegal norms that govern extralegal property**
- A.4.1 Detect and decode the extralegal norms that define the manner in which property rights are held and exercised by the different extralegal communities in the country.
- A.5 **Determine the costs of extralegality to the country**
- A.5.1 The costs to the extralegal sector
- A.5.2 The costs to the legal business sector
- A.5.3 The costs to government

B. THE POLITICAL AND LEGAL STRATEGY

B.1 Ensure that the highest political level assumes responsibility for capitalization of the poor

- B.2 **Put into operation agencies that will permit rapid change**
- B.2.1 Identify and connect with the capitalization process the different institutions that presently govern property rights or impinge upon their ability to generate surplus value.
- B.2.2 Design, obtain approval for, and put into operation agencies that will permit the rapid introduction of changes in the diverse processes required for capitalization. If possible, create a single organization having the sole mandate of capitalizing assets and decentralize offices to provide services throughout the country.
- B.2.3 Ensure that the capitalization process both incorporates the political priorities of the government and reflects a consensus within society that makes the process easily enforceable.
- B.3 **Remove administrative and legal bottlenecks**
- B.3.1 Calculate the costs of capitalizing extralegal assets, including:
 - B.3.1.1 Requirements for permits at all levels of government.
 - B.3.1.2 Requirements for and the amount of payments for these permits.
 - B.3.1.3 The number of forms and other documents required.
 - B.3.1.4 Requirements that cannot be met in practice.
 - B.3.1.5 All other transaction costs, including time delays.
- B.3.2 Remove administrative and legal bottlenecks by identifying and modifying the institutions, statutes and practices that create unnecessary red tape.
- B.4 **Build consensus between legal and extralegal sectors**
- B.4.1 Determine the points where extralegal norms coincide with the law so as to be able to draft statutes that recognize acceptable extralegal proofs of ownership with the support of extralegal communities.
- B.4.2 Ensure that the draft legal norms that incorporate extralegal property do so without compromising the level of security that the existing legal order now provides property that is duly recorded and effectively controlled so as to obtain acquiescence of the legal sector.
- B.5 **Draft statutes and procedures that lower the costs of holding assets legally below those of holding them extralegally**
- B.5.1 Enact the statutes required for all property in a country to be governed by one consistent body of law and set of procedures.
- B.5.2 Broaden the definition of proofs of ownership to suit the new process, and consolidate into administratively manageable packages the statutes and procedures that will govern the capitalization process.
- B.5.3 Consolidate dispersed legislation into a single law.
- B.5.4 Develop institutions and procedures that permit economies of scale for all the activities which constitute the process of capitalization.

- B.5.5 Create an expedient and low-cost alternative to squatting and other forms of extralegal appropriation. Consolidate process and respect for the law by establishing incentives and disincentives aimed at encouraging legal and discouraging illegal [extralegal] conveyance.
- B.5.6 Design and implement administrative or private processes, to substitute judicial processes, where suitable, so as to encourage settlement of disputes within the law.
- B.6 **Create mechanisms that will reduce risks associated with private investment, including credibility of titles and non-payment for public**
- C. **THE OPERATIONAL STRATEGY**
- C.1 **Design and implement field operation strategy, procedures, personnel, equipment, offices, training and manuals that enable government to recognize and process individual property rights in the extralegal sector**
- C.1.1 Design mechanisms to obtain the massive participation of the members of extralegal settlements for the purpose of reducing the costs of capitalization.
- C.1.2 Carry out training courses for the organization of capitalization brigades that reflect the types of extralegality they will encounter.
- C.1.3 Develop manuals that explain to the leaders and the people of extralegal settlements the ways in which they can participate in the selection and collection of proofs of ownership.
- C.1.4 Prepare for capitalizing extralegal communities
 - C.1.4.1 Identify and train local promoters within each community
 - C.1.4.2 Implement a local promotional campaign within each community
 - C.1.4.3 Educate each community about the proofs of ownership required
 - C.1.4.4 Train local leaders to record ownership information on registration forms
 - C.1.4.5 Identify and train private verifiers to certify information collected by the community.
- C.1.5 Gather and process information on physical assets.
 - C.1.5.1 Obtain or prepare maps showing the boundaries of individual parcels (where necessary prepare digital base maps to record boundary information)
 - C.1.5.2 Verify that maps showing individual parcels correspond with what is on the ground
 - C.1.5.3 Enter the maps into the computer system.
- C.1.6 Gather and process ownership information.
 - C.1.6.1 Gather ownership information and record on registration forms
 - C.1.6.2 Verify that ownership rights are valid under the new law
 - C.1.6.3 Enter the ownership information into the computer system
 - C.1.6.4 Officially register the ownership rights
 - C.1.6.5 Hand out certificates to the beneficiaries at a public ceremony.
- C.2 **Implement communications strategies using appropriate media to encourage participation of the extralegal sector, support in the business community and the government sector, and acquiescence among those with vested interests in the status quo**
- C.2.1 Conduct a campaign for each particular type of community in the extralegal sector to encourage their participation in the process.
- C.2.2 Devise mechanisms that show beneficiaries of capitalization process that their assets are protected by the same institutional framework that protects the rights of private investors, both domestic and foreign. This will give these owners a reason to respect contracts governed by the formal legal order.
- C.2.3 Conduct a campaign for each legal community that may feel vulnerable.
- C.2.4 Design the means of communicating to legal sector the benefits of capitalization, emphasizing the reduction in risks and making it clear that capitalization will neither affect existing property rights nor compromise the rights of third parties.
- C.2.5 Conduct a campaign for professionals with vested interests in property definition, explaining their future role and increased involvement within an expanded legal sector after capitalization.
- C.3 **Re-engineer the record keeping organizations and registration processes so that they can pull together all the economically useful descriptions about a country's extralegal assets and integrate them into one data/knowledge based computer system**
- C.3.1 Structure the organization of the registry and its internal work flows, simplify the registration processes, establish specifications for automating information, design and implement a quality control system, select and train personnel, and establish procedures to ensure that the registry can handle a massive national program of capitalization.
- C.3.2 Construct GIS based systems to provide spatial analytical capabilities.
- C.3.3 Establish control mechanisms to guarantee that the cost of enrollment and registration services are sufficiently efficient and cost effective that its users will not be motivated to slip back into extralegality.
- C.3.4 Insert descriptions of features of extralegal property holdings into customized, computer-friendly registration forms where they can be differentiated, recorded and managed in one computer environment.
- C.3.5 Break down the information that is traditionally contained in deeds into simple categories that can be entered into computer software and be systematized for easy access, after having effected a legally approved streamlining of existing information gathering procedures.
- C.3.6 Facilitate the update of computerized property information by placing data input centers close to the beneficiaries. The purpose is to cut down on the transportation and transaction costs of legally registering property and property-related business and keeping their status legal.
- D. **THE COMMERCIAL STRATEGY**
- D.1 **Implement the information and enforcement mechanisms that will enable the provision of:**
 - D.1.1 Banking/Mortgages/Credit
 - D.1.2 Public Utilities (Energy, water, sewage, telecommunications)
 - D.1.3 Collection Systems (Credit, rates, taxes)
 - D.1.4 Databases/Information Services
 - D.1.5 Insurance products (Property damage, life insurance, credit insurance, liens, title insurance)
 - D.1.6 National Identification Systems
 - D.1.7 Housing and Infrastructure
 - D.1.8 National Security

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PART I:

The Legal Challenge

As things stand, the creation of one integrated property system in non-Western nations is impossible. Extralegal property arrangements are dispersed among dozens, sometimes hundreds, of communities; rights and other information are known only to insiders or neighbours. 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 to launch the translation of my previous book into Bahasa Indonesian, and they took that opportunity to invite me to talk about how they could find out who owns what among the 90 per cent 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

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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 upwards, 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 re-engineering 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 are. The failure to do so explains why past attempts at legal change in developing and former communist countries have not worked. People tend to look upon the 'Social Contract' as an invisible, god-like abstraction that resides only in the minds of visionaries like Locke, Hume and Rousseau. But my colleagues and I have discovered that the social contracts of the extralegal sector are not merely implied social obligations that can be inferred from societal behaviour; they are also arrangements that are explicitly documented by real people. As a result, these extralegal social contracts can be touched, and they can also be assembled to build a property and capital formation system that will be recognized and enforced by society itself.

The Move from a Pre-capitalist to a Capitalist Property System

Without an integrated formal property system, a modern market economy is inconceivable. Had the advanced nations of the West not integrated all representations into one standardized property system and made it accessible to all, they could not have specialized and divided labour to create the expanded market network and capital that have produced their present wealth. The inefficiencies of non-Western markets have a lot to do with the fragmentation of their property arrangements and the unavailability of standard representations. This lack of integration restricts interaction not only between the legal and the extralegal sector but among the poor themselves. Extralegal communities do interchange with each other, but only with great difficulty. They are like flotillas of ships that remain in formation by navigating with reference to each other rather than to some common and objective standard, such as the stars or the magnetic compass.

Common standards in one body of law are necessary to create a modern market economy.² As C. Reinold Noyes has pointed out:

Human nature demands regularity and certainty and this demand requires that these primitive judgements be consistent and thus be permitted to crystallize into certain rules – into 'this body of dogma or systematized prediction which we call law' . . . The practical convenience of the public . . . leads to the recurrent efforts to systematize the body of laws. The demand for codification is a demand of the people to be

released from the mystery and uncertainty of unwritten or even of case law.³

To make the transition from a condition where people already rely on a diversity of extralegal practices established by mutual consent to one codified legal system is a daunting challenge. As we have seen, this is what the nations of the West had to do to move from pre-capitalist 'primitive judgements' to a systematized body of laws. That is how they lifted their bell jars. However, as successful as those nations have been, they were not always conscious of what they were doing and left behind no clear blueprint. Even in Britain, eager to extend the benefits of the Industrial Revolution, reform efforts went on for almost a full century (from 1829 to 1925) before the government was in a position to make sure that real estate assets could be centrally recorded and easily transferred. John C. Payne sums up how difficult and erratic property reform was for England:

A great many statutes were passed, and English property law was made over from top to bottom. Much of this reform was *ad hoc* improvisation, and one gets the impression that the leaders of the movement did not always have a clear idea of what they were doing or why they were doing it. English land law had become so technical and had gained so many accretions through the centuries that the task must initially have seemed almost overwhelming. The difficulty was that there was so much detail to be attended to that it was hard to get to the heart of the matter. So the English reformers began to strike about them with all good will but with more energy than clarity of concept. In the long run they did their work

well, but it took them a century to do it, and in the interim they attempted many unsuccessful experiments and were ultimately forced into a number of compromises.⁴

The Failure of Mandatory Law

One might assume that today it would be relatively easy for developing and former communist nations to lift their bell jars. After all, the right of universal access to property is now recognized by nearly every national constitution in the world and by many international conventions. Programs to endow the poor with property exist in almost all developing and former communist countries. Whereas the reforms of the West during the eighteenth and nineteenth centuries encountered widespread intellectual and moral resistance against sharing formal property rights, access to property is today considered part and parcel of the fundamental rights of humankind. A wide array of contemporary international treaties, ranging from the Universal Declaration of Human Rights of 1948 and the catechism of the Catholic Church to the 169th Covenant of the International Labour Office on Indigenous and Tribal People in Independent Countries of 1989, insist on property as a basic and stable human right. In different degrees courts and laws all over the world see this right as an important legal principle. The invading army's age-old custom of plundering property has been explicitly forbidden by international law since the International Convention of The Hague of 1899. International law thus treats the property rights of individuals as more sacred than the sovereign rights of states, providing that even if

governments lose lands, property owners in those same territories shall not lose theirs.

The United States, Canada, Japan and Europe – the twenty-five developed nations of the world – have prospered so much more than those without their kind of accessible, integrated formal property systems that today no one would seriously propose economic solutions that disregarded the need for formal property. That is why most developing and former communist nations today recognize the principle of universal access to property rights as a political necessity as well as an implicit ingredient of their macroeconomic and market reform programs.

The political intention to legalize the assets of the poor has been consecrated in Latin American law for nearly two centuries. The first Peruvian Constitution, written in 1824, just two years after independence from Spain, clearly stated that the poor, then mostly Peruvians of native origin, were the legitimate owners of their land. When it nevertheless became obvious that Peru's élites were gradually dispossessing the indigenous poor, the government enacted over the years a series of laws reinforcing the intent of the Peruvian Constitution. None of them worked. The indigenous people got statutes that generally confirmed that their assets were legally theirs. What they did not get were the mechanisms that would have allowed them to fix the economic rights over their assets in representations protected by law.

The reason is now very clear: in Peru (and many other countries outside the West) most legal procedures to create formal property are not geared to process extralegal proofs of ownership that lack any visible chain of title – which, of course, is the only kind of proof the poor have. Nor can

existing law follow and record subsequent changes in an asset's title as transactions continue to modify property relationships over time. As we saw in Chapter 2, today, in the best of circumstances, with modern maps, computers, human rights organizations standing by and all the best intentions in the world, legal procedures for recording titles and changes to them can take twenty years. From the evidence we have uncovered, it seems that Peruvian natives in the nineteenth century faced delays that were no better and probably worse. For people up against such obstacles, creating extralegal rules to protect their assets was the only rational thing to do.

When it became clear that the mandatory laws were not helping the indigenous people of Peru concretize their rights, the economic élites swung back into action, dreaming up new tricks to circumvent the laws' intent. Where official titles did not exist, the well connected and their lawyers began inventing them, reconstituting the documentary evidence and getting local authorities and notaries to issue legal titles in their favour (*títulos supletorios*, as they were called). Once again the élite dispossessed indigenous Peruvians or forced them to sell on the cheap. The government, instead of investigating why the poor were not able to use the law for their benefit, assumed that the law was not the problem but that the poor were inherently inferior. So instead of improving the law, they extracted some of the poor from the mainstream law and its leveraging tools and built firewalls around their land. In 1924 Peru enacted a major law to protect natives from further legal ploys by packing thousands of them into rural farming communities where the transfer of rights to any land was expressly prohibited. In thus protecting the natives from the scheming and swindling élites, they

also deprived them, albeit unintentionally, of the basic tools for creating capital.

These rural enclaves, however, could hold only a small percentage of the native population. By the late 1960s and early 1970s the remaining majority were still vulnerable and unhappy and, consequently, a potentially volatile class, especially with the sudden emergence of strong and well-organized leftist movements. To defuse this new threat, the Peruvian government, like those of many Third World countries, instituted agrarian reform programs that expropriated massive tracts of lands from large farms and ranches (*haciendas*) to create over six hundred government-run agrarian cooperatives for farmers. Again the aim was noble: to make sure that natives had access to real estate. What turned even these efforts into failures was that many of the indigenous people disliked working inside imposed bureaucracies. They broke up the cooperatives into private parcels of land and turned once again to more familiar and flexible extralegal arrangements to protect their newly established rights. What the government had not taken into account was that when people finally acquire property, they have their own ideas about how to use and exchange it. If the legal system does not facilitate the people's needs and ambitions, they will move out of the system in droves.

Peruvian history offers an important lesson for reformers of all political stripes. Government programs to give property to the poor have failed over the last 150 years whether they followed the bias of the right (private property rights through mandatory law) or of the left (protecting poor people's land in government-run collectives). The crippling political agendas of 'left v. right' are largely irrelevant to the needs of

most people in developing countries. These people move out of the law not because the law has privatized or collectivized them but simply because it does not address what they want. Their wants may vary. Sometimes they need to combine their properties and sometimes they need to divide them. If the law does not help them, then they will help themselves outside the law. What characterizes the enemies of property and capital formation in developing and former communist countries is not whether they are leftists or rightists, but whether they are the friends of the status quo. Governments in developing countries need to stop living on the prejudices of Westerners hung up on the cruelty of enclosure and the creation of property in Britain centuries ago or on the bloody dispossession of Native Americans throughout the Americas. Those moral debts have to be paid in the West, not abroad. What governments elsewhere have to do is listen to the barking dogs in their own countries and find out what their law should say. Only then will people stop living outside it.

Formal law is increasingly losing its legitimacy as people continue to create property beyond its reach. Our data from abroad indicated that from the 1960s to the 1990s, the extralegal sector had grown larger not only in Peru but in other developing and ex-communist nations. Presuming that the failure of mandatory law was not only a Peruvian phenomenon, in 1994 I put together a special research team to find out if in the last thirty years international financial institutions had reported carrying out any successful and massive 'formalization' program in the Third World – one where all assets were properly represented and integrated into one system so as to produce capital. Despite months of methodically sifting through the records of the US Treasury

and international organizations, we found nothing even remotely resembling the success of advanced nations.

What we did find was that over the past four decades various governments had started many such programs by earmarking billions of dollars to finance a huge array of property-related activities such as surveying, mapping and computerized recording systems. These projects had two main features in common: an extraordinary number of them had been prematurely aborted because of poor results ('Lots of new maps and computers, but few new formal owners,' reported one government project manager in Brazil); and, with the exception of some rural Thai property certification programmes, none of these efforts succeeded in turning extralegal assets into legal ones. We certainly found no evidence that assets were being transformed into capital.

Was it because governments did not really care? Certainly not. In Peru, for instance, the government had tried to formalize property at least twenty-two times in the four hundred years since the Spanish conquest. Their success rate: zero. We called on titling authorities from other developing countries and obtained similar replies: major programs had failed or had only a marginal impact. Again, and significantly, nobody we talked to in those countries could claim that any consequential number of titles issued were fungible and fixed in such a way as to be part of an integrated network where capital formation could take place.

The evidence is overwhelming: no matter how hard developing and former communist nations have tried, no matter how good their intentions, there remains an enormous distance between what mandatory law commands and what has to be done for the law to work. Mandatory law

is not enough. As Andrzej Rapaczynski has pointed out:

The notion that simply instituting an appropriate legal regime will establish a set of property rights that can undergird a modern economic system is deeply implausible, because most property rights can only be marginally enforced by the legal system. The core of the institution of ownership is a matter of unquestioned and largely unconscious social and economical practices that must be rooted in non-legal developments. This is the old Hobbesian problem: when most people obey the law, the government can enforce it effectively and [relatively] cheaply against the few individuals who break it. But when obedience breaks down on a large enough scale, no authority is strong enough to police everyone. In such a setting, with enforcement becoming less and less effective, individuals have an incentive to follow their own interests, regardless of any paper constraints.⁵

Throughout recent history, developing and former communist countries have not lacked political will, budgets, international manifestos or mandatory law drawn up with the explicit purpose of giving rights over assets to the majority of citizens. The problem is that when governments set out to ensure the property rights of poor people, they behave as if they were travelling to a place where there is a property vacuum, as if they were landing on the moon. They presume that all they have to do is fill this vacuum with mandatory law. In most cases, however, there is no vacuum. People already hold a huge amount of property through extralegal arrangements. While the assets of the poor may be outside the official law, their rights to those assets are

nevertheless governed by social contracts of their own making. And when the mandatory law does not square with these extralegal conventions, the parties to those conventions will resent and reject the intrusion.

Rooting Law in the Social Contract

Extralegal social contracts on property underpin nearly all property systems and are part of the reality of every country, even in today's United States.⁶ As Richard Posner has reminded us, property is socially constructed.⁷ This means that property arrangements work best when people have formed a consensus about the ownership of assets and the rules that govern their use and exchange. Outside the West extralegal social contracts prevail for a good reason: they have managed much better than formal law to build on the consensus between people about how their assets ought to be governed. Any attempt to create a unified property system that does not take into account the collective contracts that underpin existing property arrangements will crash into the very roots of the rights most people rely on for holding on to their assets. Efforts to reform property rights fail because officials in charge of drafting new legal rules do not realize that most of their citizens have firmly established their own rules by social contract.

The notion that social contracts underlie successful laws goes all the way back to Plato, who thought that legitimacy had to be founded on some type of social contract. Even Immanuel Kant, in his statements against Locke, wrote that a social contract has to precede real ownership; all property

rights spring from social recognition of a claim's legitimacy. To be legitimate, a right does not necessarily have to be defined by formal law; that a group of people strongly supports a particular convention is enough for it to be upheld as a right and defended against formal law.

That is why property law and titles imposed without reference to existing social contracts continually fail: they lack legitimacy. To obtain legitimacy, they have to connect with the extralegal social contracts that determine existing property rights. The problem, of course, is that these social contracts are dispersed throughout hundreds of extralegal jurisdictions in scattered villages and city neighbourhoods. The only organized way to integrate these social contracts into a formal property system is by building a legal and political structure, a bridge, if you will, so well anchored in people's own extralegal arrangements that they will gladly walk across it to enter this new, all-encompassing formal social contract. But this must be a bridge so solid that it does not crack and send everyone stampeding back into extralegal arrangements; a bridge so wide that no one falls from it. That is how, over hundreds of years, the West did it. Harold Berman reminds us:

The systematization of law within various communities . . . was possible only because there had previously developed an informal structure of legal relations in those communities . . . The Western legal tradition grew – in the past – out of the structure of social and economic interrelationships within and among groups on the ground. Behavioral patterns of inter-relationship acquired normative dimensions: usages were transformed into custom . . . and custom into law.⁸

Building a legal and political bridge from social contracts scattered 'on the ground' into one national law is what Eugen Huber did in Switzerland at the turn of the twentieth century. Huber adjusted the Roman doctrines of Swiss statutory law to the customs, rules and behaviours dispersed throughout the cities, towns and farmland of his country. He pulled together all conventions on property into one codified law that secured the rights and obligations of people in line with the local norms to which they were accustomed. Huber liked to quote an old German saying, '*Das Gesetz muss aus dem Gedanken des Volkes gesprochen sein*,' which, loosely translated, means, 'The law must come from the mouth of the people.' American law, as we saw in Chapter 5, showed the same respect for existing social contracts. Its strength was not its doctrinaire or professional coherence but its usefulness in the hands of authorities who wanted to transform undeveloped assets into productive ones.

The transitions from extralegal relations to unified formal property in advanced nations were 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: 'Law both grows upward out of the structures and customs of the whole society,' wrote Berman, 'and moves downward from the policies and values of the rulers of society. Law helps to integrate the two.'⁹

By rooting formal property law in social contracts to which people were already committed, the governments of the West achieved the widespread popular acceptance required to overcome any resistance. The result was one legal

system for property. With that in place, they were able to begin integrating dispersed conventions into one national social contract. And where once only the owner of a house and his neighbours could confirm whether the house belonged to him, with the advent of formal property the whole nation knew he was the owner. Formal property titles allowed people to move the fruits of their labour from a small range of validation into that of an expanded market. Western nations had thus laid out the energy plant to power a modern market and capitalist system.

Shifting the recognition of ownership from local arrangements into a larger order of economic and social relationships made life and business much easier. People no longer needed to rely on burdensome parochial politicking to protect their rights to assets. Formal property freed them from the time-consuming local arrangements inherent to closed societies. They could now control their assets. Even better, with adequate representations in hand, they could focus on their assets' economic potential. And because their real estate and businesses could now be located easily and identified nationally, owners lost their anonymity and became accountable. Gradually, these mechanisms of legal property set the stage for expanded markets and the creation of capital involving a huge number of players.

The Solidity of Pre-capitalist Social Contracts

Are the extralegal social contracts that prevail in developing countries today a solid enough foundation for creating official law? Without a doubt. There is a mountain of

evidence that government officials implicitly and explicitly comply with the extralegal social contracts when they operate in the undercapitalized sector. Reports of international donor organizations refer continuously, albeit obliquely, to extralegal conventions. How could governments have developed agricultural and urban renewal projects in the poorest sections of their countries without coming to terms with extralegal beneficiary organizations? The fact that governments and international financial institutions help squatter settlements put in public services (roads, electricity, water and schools), in defiance of property law, is an implicit recognition of extralegal property arrangements. As Robert Cooter and Thomas Ulen have noted, 'the terms [of property rights] are often more efficient when people agree upon them than when a law-maker imposes them'.¹⁰

Extralegal social contracts rely on a combination of customs, *ad hoc* improvisations and rules selectively borrowed from the official legal system. In the absence of legal protection from the state in most developing nations it is extralegal law that regulates the assets of most citizens. 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. As Margaret Gruter succinctly puts it:

Law is . . . not simply a set of spoken, written or formalized rules that people blindly follow. Rather, law represents the formalization of behavioral rules, about which a high percentage of people agree, that reflect behavioral propensities

and that offer potential benefits to those who follow them. (When people do not recognize or believe in these potential benefits, laws are often disregarded or disobeyed . . .)¹¹

Another legal scholar has noted that the West's 'modern reliance on government to make law and establish order is not the historical norm'.¹² Diverse laws within one nation are nothing new. Legal pluralism ruled continental Europe until Roman law was rediscovered in the thirteenth and fourteenth centuries and all currents of law were gradually brought into one coordinated system.

We should not be surprised, then, to find that extralegal activity in developing and former communist countries is rarely haphazard. In the course of issuing formal title to hundreds of thousands of home and business owners in Peru my organization never found an extralegal group that did not comply with well-defined consensual rules. Whenever we visited an undercapitalized area, whether in Asia, America or the Middle East, we never stepped into a wilderness. By observing carefully, we were always able to distinguish patterns of rules. In the worst cases we found a neglected garden – never a jungle.

Like their Western predecessors, the undercapitalized sectors in the Third World and ex-communist countries have spontaneously generated their own varieties of property rules. To defend their incipient property rights from others, they have been forced to work out among themselves their own extralegal institutions. Remember, it is not your own mind that gives you certain exclusive rights over a specific asset, but other minds thinking about your rights in the same way you do. These minds vitally need each other to protect

and control their assets. Moreover, people need to make their social contracts even stronger than formal law to fend off intruders, especially the government. Anyone doubting the strength of social contracts has only to challenge some of these extralegal rights. The resistance will be most impressive.

Extralegal arrangements have become astonishingly widespread over the past forty years. Reports about 'the mushrooming extralegal sector' seem as common as football scores in the newspapers of practically every Third World city. The reason is that formal law has not been able to accommodate rapidly evolving extralegal agreements. In real estate, for example, extralegal social contracts originate not only from outright squatting by migrants, but from deficient housing and urban or agrarian reform programs, the gradual deterioration of rent control programs, and the illegal purchase or lease of land for dwelling and industrial purposes. Most social contracts are facilitated by active agents: commercially, politically or religiously motivated 'real estate brokers' who have either something to gain from these transactions or a constituency to protect. The common denominator among their clients is that they cannot pay the costs of legally obtaining property. In some countries I have visited, branches of the armed forces appoint military officers to obtain real estate extralegally as living quarters for non-commissioned officers. More surprising still, I have seen municipal authorities in charge of real estate titling and registry operations organize informal squatting in order to provide their union members with decent land for their homes. One large squatter settlement I visited recently was initiated by the city council itself, to provide homes for some

seven thousand families of government employees. In another country a local newspaper, intrigued by our evidence of extensive extralegal real estate holdings, checked to see if the head of state's official residence had a recorded title. It did not. The newspaper joked that the nation's laws were being enacted from an extralegal location.

Once rights to land have been created extralegally, those involved create institutions to administer the social contract they have built: informal business and residential organizations meet regularly, make decisions, obtain and supervise infrastructure investment, follow administrative procedure and issue credentials. They typically have a headquarters where maps and manual ledgers with ownership records may be found. The most striking feature of these institutions, throughout the world, is their desire to be integrated into the formal sector. In urban areas extralegal buildings and businesses evolve over time until they are barely distinguishable from property that is perfectly legal. In all developing and former communist nations I have visited a long frontier separates the legal from the extralegal. All along it there are checkpoints where extralegal organizations connect with government officials; where the former struggle to gain official acceptance and the latter try to achieve a semblance of order.¹³ Usually, extralegal organizations will have worked out a way to coexist with some stratum of the government, probably at the municipal or local level. Most groups are trying to negotiate a legal niche to protect their rights, while others have already reached some sort of agreement that stabilizes their situation outside mainstream law. There is one other clue pointing to the fact that the extralegals want to come in from the cold: the engaging and diplomatic leaders

they select to negotiate on their behalf hardly fit the stereotype of the street boss.

Listening to the Barking Dogs

Most governments of developing and former communist nations are probably ready to recognize that the reason why their extralegal sectors are growing exponentially is not because people have suddenly abandoned their respect for the law but because they have no alternative for protecting their property and earning a living. Once governments come to terms with this fact of modern life, they will have to strike a deal. Although the extralegals are already primed to cross the bridge into legal recognition, they will do so only if their governments make the trip easy, safe and cheap. Asset owners in the extralegal sector are already relatively well organized; they are also 'law-abiding', although the laws they abide by are not the government's. It is up to the government to find out what these extralegal arrangements are and then find ways to integrate them into the formal property system. But they will not be able to do that by hiring lawyers in high-rise offices in Delhi, Jakarta or Moscow to draft new laws. They will have to go out into the streets and roads, and listen to the barking dogs.

The law that prevails today in the West did not come from dusty tomes or official government statute books. It is a living entity, born in the real world and bred by ordinary people long before it got into the hands of professional lawyers. The law had to be discovered before it could be systematized. As the legal scholar Bruno Leoni reminds us:

The Romans and the English shared the idea that the law is something to be *discovered* more than to be *enacted* and that nobody is so powerful in his society as to be in a position to identify his own will with the law of the land. The task of 'discovering' the law was entrusted in their two countries to the jurist consult and to the judges, respectively – two categories of people who are comparable, at least to a certain extent, to the scientific experts of today.¹⁴

'Discovering the law' is precisely what my colleagues and I have been doing in various countries for the past fifteen years as a first step towards helping governments in developing countries build formal property systems that embrace all their people. When you push aside the Hollywood stereotypes of Third Worlders and ex-communists as a motley assortment of street vendors, mustachioed guerrillas and Slavic gangsters, you will find few differences between the cultures of the West and elsewhere when it comes to protecting assets and doing business. After years of study in many countries I have become convinced that most extralegal 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 authorized for each transaction.

It is fair to assume, therefore, that people are prepared to think about property rights in very similar ways. This should not come as a big surprise; folk conventions have always spread by analogy from one place to another spontaneously. Moreover, the massive migrations of the past forty years, not to mention the worldwide revolution in communications, mean that we are sharing more and more values and ambitions. (Third Worlders watch TV, too; they also go to the movies, use telephones and want their children to have good educations and become computer literate.) It is inevitable that individual extralegal social contracts in the same country will be more alike than different.¹⁵

The problem with extralegal social contracts is that their property representations are not sufficiently codified and fungible to have a broad range of application outside their own geographical parameters. Extralegal property systems are stable and meaningful for those who are part of the group, but they do operate at lower systemic levels and do not have representations that allow them to interact easily among each other. Again, this is similar to the past of the West when official titles did not exist. Before the fifteenth century in Europe, for example, even though some isolated registries did exist in some parts of what is today Germany, most official rules on how property transactions ought to work were unwritten and known only through oral traditions.

Many view those rituals and symbols as the representational predecessors of official titles, shares and records today. According to the eighteenth-century British

philosopher and historian David Hume, in certain parts of Europe during his day landowners passed stones and earth between each other to commemorate the exchange of land; farmers symbolized the selling of wheat by handing over the key to the barn where it had been stored. Written parchments testifying to property transactions on land were ritually pressed to the soil to represent the agreement. Similarly, centuries before in Imperial Rome, Roman law provided that grass and branches were to be passed from hand to hand to represent the legal transfer of property rights. The Japanese, too, had their own ritual confirmations of transactions; for example, in the region of Gumma Kodzuke, during the Tokugawa period from the seventeenth to the nineteenth century when the sale of agricultural land was forbidden by law, land holders transferred their assets anyway, confirming these extralegal deals in written documents sealed by the seller's relatives and the village leader. Gradually, the written documents were collected in local registries. It took time before these representations were put in book form. But it was only during the nineteenth century that these different property registries and the social contracts governing them were standardized and brought together to create the integrated formal property systems that the West has today.

The former communist nations and the Third World are exactly where Europe, Japan and the United States were a couple of hundred years ago. Like the West, they must identify and gather up the existing property representations scattered throughout their nations and bring them into one integrated system to give the assets of all their citizens the fungibility, bureaucratic machinery and network required to produce capital.

Decoding Extralegal Law

When my colleagues and I first faced the task of integrating pre-capitalist property arrangements into a capitalist formal property system, the West was our inspiration. But when we started searching for the information on how the advanced nations integrated their extralegal arrangements into law, there were no blueprints for us to study. How Western nations identified which categories of extralegal proofs of property would be the common denominators of a standardized formal property system is unfortunately poorly documented. John Payne explains the situation in England:

Formal proof of title as a part of commercial land transactions is apparently a late development in English law but present information is so scant as to make such a hypothesis merely tentative. It is a source of exasperation to the historian that, while great events are chronicled in detail, people seldom feel it necessary to set down an account of the homely, everyday activities in which they engage. To do so would appear superfluous and banal, for no one wants to be reminded of the obvious. Consequently what everyone takes for granted in one era is unknown in the next, and the reconstruction of ordinary procedures requires painstaking piecing together of sources left for an altogether different purpose. This is certainly true of the practices of conveyancers, for, until the [nineteenth] century we have only limited knowledge of how they actually carried on their work.¹⁶

Guided by the few historical records we could find and filling the gaps with our own empirical research, we Brailled our

way through extralegal worlds and eventually learned how to get in touch with the social contracts that underlay property rights there. Discovering these arrangements is nothing like searching for proofs of ownership in a formal legal system, where you can rely on a record-keeping system that has over the years created a paper trail, a 'chain of title', that allows you to search for its origin. In the undercapitalized sector, the chain of title is blurry, at best, to the outsider. The undercapitalized 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 undercapitalized sector do have are strong, clear and detailed understandings among themselves of who owns what today.

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. If property is like a tree, the formal property system is diachronic, in the sense that it allows you to trace the origins of each leaf back in time from twig and branch to the trunk and finally to the roots. The approach to extralegal property has to be synchronic: the only way an outsider can determine which rights belong to whom is by slicing the tree top at right angles to the trunk so as to define the status of each branch and leaf in relation to its neighbours.

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 undercapitalized urban sector 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' (see Figure 6.2 for a selection of informal Haitian titles). Everywhere we have been in the world, most informals have some 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 extract the social contracts undergirding property.

While extralegal sources of information to identify property conventions are important, there are also official and legal sources. Politicians at the top are rarely conscious of the extent to which people at lower administrative levels of government are constantly in touch with the extralegal sector. Municipal authorities, urban planners, sanitation officers, police and many others have to produce official assessments of the extent of illegality of the informal settlements or groups of new businesses that are sprouting constantly throughout their districts. We have learned how to read official documentation to spot areas where extralegal social contracts prevail.

Once governments know where to look for extralegal representations and get their hands on them, they have found the Ariadne's thread leading to the social contract.

Figure 6.2
PROOFS OF OWNERSHIP USED BY INFORMALS IN HAITI

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, businesslike 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. As John P. Powelson correctly concludes in *The Story of Land*, even in primitive rural areas of developing nations the people themselves have been their own most effective advocates and have always had the capacity to represent themselves intelligently.¹⁷

When governments obtain documentary evidence of representations, they can then 'deconstruct' them to identify the principles and rules that constitute the social contract that sustains them. Once reformers have done that, they 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; 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

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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 is the way for developing and ex-communist nations to meet the legal challenge and was basically how Western law was built: by gradually discarding what was not useful and enforceable, and absorbing what worked.

If all this sounds more like an anthropological adventure than the basis for legal reform, it is because knowledge about the poor has been monopolized by academics, journalists and activists moved by compassion or intellectual curiosity rather than by the nuts and bolts of legal reform. Where have the lawyers been? Why haven't they taken a hard look at the law and order that their own people produce? The truth is that lawyers in these countries are generally too busy studying Western law and adapting it. They have been taught that local practices are not genuine law, but a romantic area of study best left to folklorists. But if lawyers want to play a role in creating good laws, they must step out of their law libraries into the extralegal sector, which is the only source of the information they need to build a truly legitimate formal legal system. By examining this 'people's law' and understanding its logic, reformers can get a sense of what they need to do to create a self-enforcing legal system.

When they have done this, governments will have literally touched the social contract. They will have the information

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required to integrate the poor and their possessions into a legal framework, so that they may finally begin to have a stake in the capitalist system. But implementing legal reform will mean tampering with the status quo. That makes it a major *political* task.

PART II: The Political Challenge

Nobody planned the evolution from feudal and patrimonial systems to the modern property systems that exist in the West today. However, on the long evolutionary path to modernity, in those stretches of the journey when reformers embarked on deliberate programs to make property more accessible to a wider range of citizens, these programs were successful because they were supported by well-thought-out political strategies. That is what Thomas Jefferson did in Virginia at the end of the eighteenth century, when he increased the fungibility of property by abolishing, among other things, the practice of entail (not being able to transfer property outside the family). When Stein and Hardenberg set the stage for universal property rights in Germany at the beginning of the nineteenth century, and when Eugen Huber, in Switzerland at the beginning of the twentieth century, began to integrate all the dispersed property systems of his country, they likewise employed carefully planned strategies to storm the barricades of the status quo. They made sure that they were armed with astutely aimed legislation that permitted government to create popularly supported, bloodless revolutions that could not be halted.

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Why do you need a political strategy today? Who could possibly be against removing so obviously unjust a legal apartheid? Few, in fact, would dispute the need for reform. But a tiny, powerful minority will intuit that reform is bound to perturb their little niches, and they will resist silently and insidiously. There is also a related problem: many of the statutes that wall off the majority of people from capital may also contain provisions that protect vital interests of powerful groups. Opening up capitalism to the poor will not be as simple as running a bulldozer through garbage. It is more like rearranging the thousands of branches and twigs of a huge eagle's nest – without irritating the eagle. Although this rearrangement will impose only small inconveniences on this tiny minority, in comparison to the nationwide benefits of bringing capital to the poor, those affected will not see this unless reform is driven by a strong political initiative with the message and numbers to back it up.

Clearly, this is a job for experienced political operatives with the sophistication to rearrange the eagle's nest without being clawed. They are the only ones in a position to synchronize change for the majority and stability for the wary minorities. 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, a president or prime minister who is more than a mere technocrat has to take charge and make formalization a pillar of government policy. Only at the highest political level can reform command overwhelming support and wipe out the wilful inertia of the status quo. Only the top level of government can prevent bureaucratic infighting and political conflicts from paralysing the progress of reform. Whenever a nation sets out to make

a major change, whether to stabilize money, privatize government agencies or open up the schools to all races, the head of state steps forward to lead the charge. Emancipating the poor surely falls within the responsibilities of the nation's leader.

History and personal experience have taught us that, to make a property revolution, a leader has to do at least three specific things: take the perspective of the poor, co-opt the élite and deal with the legal and technical bureaucracies that are the bell jar's current custodians.

Taking the Perspective of the Poor

Everyone will benefit from globalizing capitalism within a country, but the most obvious and largest beneficiary will be the poor. With the poor on his side, a leader intent on reform has 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. But, to win, he or she will have to acquire the facts necessary to build a case. This involves carrying out original research: reformers have to put themselves in the shoes of the poor and walk their streets. Official statistics do not contain the information they need. The facts and figures can only be seen from outside the bell jar.

When I began studying the possibility of giving the poor access to formal property in Peru in the 1980s, every major law firm I consulted assured me that setting up a formal business to access capital would take only a few days. I knew this was true for me and my lawyers, but I had a hunch it was not true for the majority of Peruvians. So my colleagues and I decided to set up a two-sewing-machine garment factory in

a Lima shanty town. To experience the process from the point of view of the poor, we used a stopwatch to measure the amount of time a typical entrepreneur in Lima would have to spend to get through the red tape. We discovered that to become legal took over three hundred days, working six hours a day. The cost: thirty-two times the monthly minimum wage. We performed a similar experiment to find out what it would take for a person living in an extralegal housing settlement, whose permanence the government had already acknowledged, to acquire legal title to a home. To receive approval from only the municipality of Lima – just one of the eleven governmental agencies involved – took 728 bureaucratic steps (see Figure 6.3). This confirmed what I suspected from the beginning: most conventional data reflects the interests of those, like the lawyers I consulted, who are already inside the bell jar. That is why the bell jar can be seen only from the outside looking in: from the perspective of the poor.

Once government obtains this information, it will be able to explain its intent in a way the poor can understand and relate to. As a result, they will support the agenda of reform enthusiastically. The poor will become the most effective public relations machine for reform, providing the feedback from the streets necessary to keep the program on course.

This is what happened in Peru. From 1984 to 1994 my colleagues and I directed all our efforts to informing the public about the benefits of lifting the bell jar (at the time we called it 'formalization'). Our objective was to prove to the politicians that there was a hidden national consensus for reform and that formalizing the assets of the poor was politically a winning strategy. By the late 1980s the polls confirmed this: our proposals to change the formal property

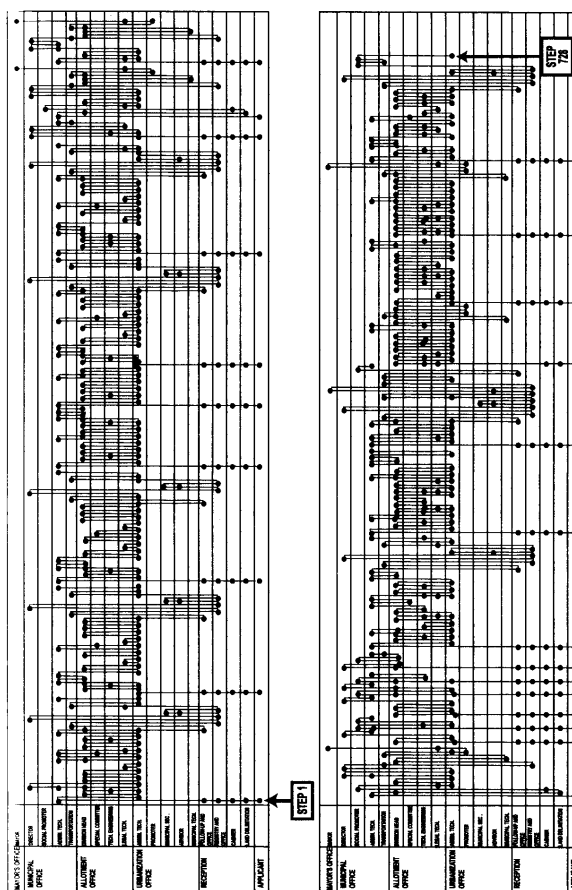


Figure 6.3
728 BUREAUCRATIC STEPS REQUIRED BY THE MUNICIPALITY OF
LIMA TO OBTAIN LEGAL TITLE TO A HOME IN A
VALIDATED HOUSING SETTLEMENT

system had an approval rating of nearly 90 per cent. With numbers like that, it was not surprising that when the first pieces of legislation and regulations that my organization drafted for formalization came before the Peruvian Congress in 1988 and early 1990, they were unanimously approved. During the 1990 presidential campaign every candidate, including Mario Vargas Llosa, the novelist and candidate of the libertarian-conservative coalition, and Alberto Fujimori, the dark-horse populist and eventual winner, along with the outgoing socialist president Alan Garcia, subscribed to the agenda of formalization. Even today, in spite of implementation efforts that have been erratic and very incomplete, formalization is an uncontested and permanent fixture on the Peruvian political landscape.

With the facts, figures and public opinion all on the side of reform, the government will be in a position to move the whole issue of poverty dramatically into its agenda for economic growth. Relieving poverty will no longer be seen as a charitable cause, to be undertaken if and when it ever becomes affordable. On the contrary, the future of the poor can now top the list of the government's program for growth.

Co-opting the Élites

Once the economic potential of the poor – the largest constituency in the nation – has been revealed and their support for reform is manifest, reformers will have the attention of the élite. This is the moment to break their illusion that lifting the bell jar benefits only the poor. It is not only that bridging the gap between classes is a general social

good. This kind of legal integration can help almost every interest group in the nation. Just as reformers collected facts and numbers to win the support of the poor, they must use other facts and figures to win over vested interests. The élites must support reform not out of patriotism or altruism but because it will also enlarge their wallets.

For example, bringing the extralegal sector inside the law will open up the opportunity for massive low-cost housing programs that will provide the poor with homes that are not only better built but much cheaper than what they themselves have been building in the extralegal sector. Creating a home in the topsy-turvy world of the extralegal sector is equivalent to getting dressed by putting on your shoes first, then your socks. Consider what it takes for a new migrant from a rural area to create a home for his family in a shanty town outside a large city. First, he not only has to find a spot for his house, but has to occupy the land *personally*, with his family. The next step is to set up a tent or shelter made from, depending on the country, straw matting, mud bricks, cardboard, plywood, corrugated iron or tin cans – and thus stake out a physical claim (because a legal one is unavailable). The migrant and his family will then gradually bring in furniture and other household items. Obviously, they need a more livable and durable edifice. But how to build it without access to credit? They do what everyone else does – stock solid building materials and begin to build a better house, stage by stage, according to what kinds of material they can accumulate.

Once the inhabitants of one of these new neighbourhoods have organized enough to protect their holdings or the local authorities take pity on their deprivation, they can bring in pavement, water, waste-disposal and electricity – typically at

the cost of having to destroy parts of their houses in order to hook up to the utilities. Only after years of building and rebuilding, and saving construction materials, are these homeowners finally in a position to live comfortably.

In the West creating a home is the equivalent of putting on your socks before your shoes, and is thus much less hazardous, expensive and degrading. A developer typically holds title to the land which gives him the security to develop the infrastructure (paved roads, utilities, etc.). Then he sells the house, which he proceeds to build according to the buyer's preferences. The new owners, who have probably borrowed most of the price of the house from a bank, will then move their furniture in and, finally, the kids and the cat.

At the moment when the poor become accountable under formal law they will be able to afford low-cost housing and thus escape from the topsy-turvy world of the extralegal sector. The élites will then begin to collect their rewards as well: builders and construction material manufacturers will find their markets expanding, as will banks, mortgage companies, title agencies and insurance firms. Formalization will also help the suppliers of public utilities to convert home addresses into liable terminals. It will provide governments and businesses with information and addresses for merchandising, securing interests and collecting debts, fees and taxes. In addition a formal property system supplies a database for investment decisions in healthcare, education, tax assessment and environmental planning.

Widespread legal property will even help solve one of their loudest and most persistent complaints about the expanding urban poor – the need for more 'law and order'. Civil society in market economies is not simply due to greater prosperity.

The right to property also engenders respect for law. As the eminent historian Richard Pipes pointed out in his book about the Russian Revolution:

Private property is arguably the single most important institution of social and political integration. Ownership of property creates a commitment to the political and legal order since the latter guarantees property rights: it makes the citizen into a co-sovereign, as it were. As such, property is the principal vehicle for inculcating in the mass of the population respect for law and an interest in the preservation of the status quo. Historical evidence indicates that societies with a wide distribution of property, notably in land and residential housing, are more conservative and stabler, and for that reason more resilient to upheavals of all sorts. Thus the French peasant, who in the eighteenth century was a source of instability, became in the nineteenth, as a result of the gains of the French Revolution, a pillar of conservatism.¹⁸

When poor people have confidence that their land and businesses 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 civilized restraint. In developing and former communist nations one of the chief characteristics of outlaws is not having a legal address. When a crime is committed, police do not have the records, leads and other property-based information necessary to 'skip trace' prime suspects. That is why law enforcement authorities cannot be as selective as their Western

counterparts when rounding up suspects and are thus more likely to violate people's civil rights.

Owning formal property also tends to discourage unruly behaviour. When people are forced to divide their property into smaller and smaller parcels, the heirs of their heirs, crowded off the family land, are more likely to squat elsewhere. Also, when a person cannot prove he owns anything he is more likely to have to bribe his way through the bureaucracy, or with the help of his neighbours, take the law into his own hands. Worse still, without good law to enforce obligations, society in effect invites the gangsters and terrorists to do the job. My colleagues and I have carried out formal titling campaigns that have displaced terrorists by co-opting their role as the area's security force against the real or imagined threat of land expropriation.

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, and because their property arrangements appear in no official system, law enforcement cannot even find them, never mind work out an enforceable crop-substitution agreement. This lack of legal protection also means that growers of drug crops have to band together to defend their assets or call on traffickers to defend them. Without a formal property system that includes such landowners, controlling growers of drug crops, chasing drug traffickers and identifying environment polluters becomes virtually impossible. There is no way for authorities to penetrate the tight extralegal arrangements the people create to protect their interests.

Legalizing property is hardly mere charity for the poor. Creating an orderly market that makes owners accountable and gives their homes clear titles worthy of financing will generate an expanded market, encourage law and order and put money into the pockets of the élite.

Dealing with the Custodians of the Bell Jar

Once reformers have the poor and at least some of the élite 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.

The Lawyers

In theory the legal community should favour reform because it will expand the rule of law. But most lawyers in developing and former communist countries have been trained not to expand the rule of law but to defend it as they found it. Lawyers are the professionals most involved in the day-to-day business of property. They sit in the key government offices where they exert a stranglehold on major decisions. No group – aside from terrorists – is better positioned to sabotage capitalist expansion. And, unlike terrorists, the lawyers know how to do it legally.

Although entrepreneurs and ordinary people are the builders of capital and capitalism, it is the lawyers who fix property concepts in tangible representative form and define those concepts in statutes. The security of ownership, the

accountability of owners and the enforceability of transactions must ultimately be concretized in procedures and rules drafted by lawyers. It is the legal profession that perfects all the artefacts of formal property: titles, records, trademarks, copyrights, promissory notes, bills of exchange, patent rights, shares of corporate stock. Whether you like lawyers or not, no genuine change in the property regime and the capital formation process will take place without the cooperation of at least some of them.

The difficulty is that few lawyers understand the economic consequences of their work, and their knee-jerk reaction to extralegal behaviour and to large-scale change is generally hostile. All the reformers I have met working to make property more accessible to the poor operate with the presumption that the legal profession is their natural enemy. Economists involved in reform have become so frustrated with legal conservatism that they have invested time and money to discredit the legal profession. Using economic data from fifty-two countries from 1960 to 1980, Samar K. Datta and Jeffrey B. Nugent have shown that for every percentage point increase in the number of lawyers in the labour force (from, say, 0.5 to 1.5 per cent), economic growth is reduced by 4.76 to 3.68 per cent – thus showing that economic growth is inversely related to the prudence of lawyers.¹⁹

What especially irritates many reformers is how lawyers shift the blame for bad property systems to other people. I have often heard lawyers commending existing property law, while in the same breath conceding that legally issued property titles were difficult or impossible to use. This is, of course, unacceptable. A lawyer cannot design the law and the administrative procedures for implementing it and then

blame its failure on the inadequacies of the low-level technocrats who implement the law or the poor education of those who use it. It is not enough to draft elegant laws. They must also work in the administrative and social reality for which they were drafted.

Interestingly, the strongest criticism of lawyers' efforts to stall property reform often comes from their fellow-attorneys. S. Rowton Simpson, a lawyer and the world's most renowned author on the subject of land registration, writes of his colleagues:

Lawyers, the world over, are notorious for their reluctance to accept even the smallest changes in their traditional procedures . . . Torrens [the Australian creator of one of the world's most secure recording systems], who was opposed tooth and nail by the legal profession, overcame the opposition of the lawyers in South Australia; but his story is exceptional. It takes a diamond to cut a diamond, and in most countries registration of title has, as a rule, owed its introduction to the efforts of a lawyer, handicapped as he may have been by the active opposition of the practising members of his profession; and passive opposition may be even worse than active, which at least either wins or is defeated. Passive opposition is more insidious; it can stultify progress. Not a few statutes have withered on the vine after receiving a welcome from practitioners which proved to be merely lip service or even 'the kiss of death'; other statutes have had built into them a procedure so long-term as to make progress almost imperceptible; such statutes certainly offer no dangers to established practice, and so tend to be acceptable to the legal profession, but they do not really achieve the objective;

they merely swell the list, if not of failures, at least of 'non-successes'.²⁰

Although lawyers often concede that other disciplines have to be dynamic, they argue that the law must be stable. Such veneration of the rule of law, no matter the consequences, can reach the point where attorneys who support reform risk ostracism by their peers. In German-speaking countries during the nineteenth and early twentieth centuries the legal profession's hostility towards property reform ran so high that any reformist lawyer was called a *Mestbeschmutzer* – a beast that fouls its own nest.

The good news for reformers is that the most brilliant (but not necessarily the most successful) lawyers believe that law is made to serve life and not the other way around. Forward-looking jurists ultimately triumphed over the reactionary tendency of their profession in the West, even in the context of Roman law. To be sure, the battle was uphill all the way, mainly because, as Peter Stein has remarked, lawyers' 'contribution to a proper understanding of legal institutions was obscured by their emphasis on antiquarianism and their acceptance of Roman law as a finished product'.²¹ Nevertheless, over time, great European jurists overcame excessive rigidity because, as Stein points out, they 'made it their profession to become experts in the intricacies of the Roman law, and to ensure that it moved with the time'.²² Against their colleagues' rampant unresponsiveness, in every European country an élite band of lawyers emerged to help lift the bell jar.

Any government eager to pursue an integrated property system must therefore draw up a careful strategy for dealing

with the legal profession. The key is choosing the right lawyers. It takes a wise and cunning political leader to avoid the lawyers skilled at the subtleties of scaring politicians into a state of immobility and to find instead those who will give legal form to an agenda for transformation even if it means bucking the system. Unless the reform-minded politician hand-picks his lawyers, he will be at the mercy of the ruling legal technocrats who will give lip service to reform while subverting it in the shadows.

Courageous, reform-minded lawyers exist in every nation, and once the selection criteria for such qualities is clear, the right people can be identified. Many understand that the primary determinants of change rest outside the law. In every country I have visited I have found groups of government lawyers very familiar with the extralegal sector, striving daily to find harmony between the formal system and the extralegal arrangements. Some academic lawyers are also acutely aware that the parallel orders of legal and extralegal law operate simultaneously. But their work tends to go unnoticed in the higher reaches of government, and so they, too, remain invisible. Indeed, it is nearly a rule that lawyers who are clued in to the existence of the two orders and are sympathetic with reform are pushed to the margins of political decision-making.

It is these people whom the political leadership must marshal to storm the status quo and implement an irresistible national programme to formalize property. Such an army, however, does not step forward spontaneously. Each lawyer must be located and recruited. Altogether, they will form the vanguard that can make the case of reform to their fellow-lawyers. It is they who will be able to beat back the dinosaurs and explain to the legal profession in its own language how

crucial it is to their own and their nation's future to integrate all property into one unified legal system open to all people. They alone can explain to the rest of the profession that existing legal procedures have become not simply a nuisance but *the* insurmountable obstacle that keeps most of the people of the world from being in a position to create capital. Lawyers are human, too. Once they understand that the system they defend is hopelessly outdated, they will react positively.

The Technicians

Developing and former communist countries are forever spending hundreds of millions of dollars on mapping and computerized record-keeping technology to modernize their property systems – and they still cannot integrate their extra-legal sectors. This no longer surprises anyone who has thought hard about the priorities of property reform. In 1993 a World Bank expert warned that 'There has been a tendency to consider land titling a technical problem. Often the maps are made and surveys carried out, but the titles are not made or issued because of a blockage in systems or legal problems'.²³

Even the technicians are concerned that they may be too mesmerized by the amazing new technologies. One of Canada's foremost experts in land and information systems has expressed concern that some governments continue to view mapping as the cornerstone of property:

We are currently in danger of perpetuating this myth by trying to reduce resource management to a geographical information system (GIS) problem. Technology is attractive; it produces tangible results. But it is only part of the solution . . .

Consultants and aid organizations frequently export systems they are familiar with (usually their own or ones they have worked with) without giving sufficient consideration to the needs and constraints of the recipient country . . . There is a need for more modesty among professional consultants; there is a need to occasionally admit that they do not always know the answer or that their system may not be appropriate.²⁴

Property creation programmes will continue to fail as long as governments think that creating property only requires getting acquainted with physical things – 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. They do not. 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. All the photographs and computer inventories in the world cannot tell anyone what local rules enforce these rights or what network of relationships sustains them. As important as maps and inventories are to measure and locate the physical assets to which property is anchored, they do not tell governments how to build the national social contract that will enable them to create widespread legal property.

The propensity in some countries to squeeze the issues related to property into the departments of mapping and information technology has obscured the real nature of property. Property is not really part of the physical world: its natural habitat is legal and economic. Property is about invisible things, while maps are resemblances of physical

things on the ground. Maps capture the physical information of assets but miss the big picture. Without the pertinent institutional and economic information about extralegal arrangements they cannot capture the reality outside the bell jar. They are thus unable to do their real job, which is to help anchor the property aspects of assets in physical reality so as to keep virtuality and physicality in sync.

Until the obstacles to using formal property systems are removed and the extralegal arrangements have been replaced by the law, people have little incentive to supply the information necessary to keep maps and data bases updated and reliable. People do not want to get inside the formal property system because they are eager to be mapped, recorded or taxed; they will join the 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.

This is not a trivial point. Technically driven titling projects tend to degenerate into identification systems for physical stock, outdated Domesday Books or historical relics. The mapping and computer industries suffer as a result. Their project budgets are approved by politicians who expect that these new methods will incorporate the poor. Once they realize they do

not, the mapping projects get scaled down or terminated. My team and I have found this happening time and again.

These technologies work so well in advanced nations, without the need for much legal and political tinkering, because the tinkering was done more than a hundred years ago. The all-encompassing social contract on property is already firmly in place. When the database systems, geographical information systems, remote sensing, global positioning system, and all the wonderful information technology tools became available during the last thirty years, they could fit neatly into a well-integrated information and legal infrastructure. Thus the written and graphic representational devices, and facilities for better storage, retrieval and manipulation of information, could be put to good use.

I am not saying that engineering, systems integration, information technology companies, equipment vendors, registry advisers and all the others who provide property documentation services specialized in surveying, mapping and the modernization of registries are unimportant to property creation – quite the contrary. If appropriately adapted to massive registration and to operating in an extralegal environment, they are indispensable for defining physical locations as well as for processing and integrating information. They will consume most of the money spent on property reform, but only after the legal and political problems of bringing in the extralegal sector are solved.

Only true political leadership can coax the law of property out of its preoccupation with the past and into an appreciation of the present; from being much too impressed with technology to becoming concerned with the good of society. Politicians are

needed because existing institutions are inclined to favour and protect the status quo. It is a political task to persuade technocracy to make itself over and support change.

Political intervention is also necessary because government organizations within the bell jar are generally not designed to undertake swift, broad reform programs. They are usually organized as specialized departments, a structure that makes more sense in developed nations, where only gradual change is necessary because the law and formal property are already functioning for all. Property creation is not at all like a privatization programme, which only involves selling a dozen or so bundles of assets a year. The goal of property reform is to award property rights for millions of assets to millions of people in a short time. This means that at least half the job is about communications. The leaders of property reform 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.

Creating a property system that is accessible to all is primarily a political job because it has to be kept on track by people who understand that the final goal of a property system is not drafting elegant statutes, connecting shiny computers or printing multicoloured maps but putting capital in the hands of the whole nation.

7

BY WAY OF CONCLUSION

Where is the wisdom we have lost in knowledge?

Where is the knowledge we have lost in information?

T.S. ELIOT, *Choruses from 'The Rock'*

The Private Club of Globalization

Capitalism is in crisis outside the West not because international globalization is failing but because developing and ex-communist nations have been unable to 'globalize' capital within their own countries. Most people in those nations view capitalism as a private club, a discriminatory system that benefits only the West and the élites who live inside the bell jars of poor countries.

More people throughout the world may wear Nike shoes and flash their digital watches, but even as they consume the goods of the West, they are quite aware that they still linger at the periphery of the capitalist game. They have no stake in it. Globalization should not be just about interconnecting the bell jars of the privileged few. That kind of globalization has existed before: in the nineteenth century Europe's ruling