

ALSO BY HERNANDO DE SOTO

*The Other Path*

THE MYSTERY OF  

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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.*

## CHAPTER ONE

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# The Five Mysteries of Capital

*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?*

—Fernand Braudel, *The Wheels of Commerce*

THE HOUR OF capitalism's greatest triumph is its hour of crisis. The fall of the Berlin Wall ended more than a century of political competition between capitalism and communism. Capitalism stands alone as the only feasible way to rationally organize a modern economy. At this moment in history, no responsible nation has a choice. As a result, with varying degrees of enthusiasm, Third World and former communist nations have balanced their budgets, cut subsidies, welcomed foreign investment, and dropped their tariff barriers.

Their efforts have been repaid with bitter disappointment. From Russia to Venezuela, the past half-decade has been a time of economic suffering, tumbling incomes, anxiety, and resentment; of "starving, rioting, and looting," in the stinging words of

Malaysian prime minister Mahathir Mohamad. In a recent editorial the *New York Times* said, "For much of the world, the marketplace extolled by the West in the afterglow of victory in the Cold War has been supplanted by the cruelty of markets, wariness toward capitalism, and dangers of instability." The triumph of capitalism only in the West could be a recipe for economic and political disaster.

For Americans enjoying both peace and prosperity, it has been all too easy to ignore the turmoil elsewhere. How can capitalism be in trouble when the Dow Jones Industrial average is climbing higher than Sir Edmund Hillary? Americans look at other nations and see progress, even if it is slow and uneven. Can't you eat a Big Mac in Moscow, rent a video from Blockbuster in Shanghai, and reach the Internet in Caracas?

Even in the United States, however, the foreboding cannot be completely stifled. Americans see Colombia poised on the brink of a major civil war between drug-trafficking guerrillas and repressive militias, an intractable insurgency in the south of Mexico, and an important part of Asia's force-fed economic growth draining away into corruption and chaos. In Latin America, sympathy for free markets is dwindling: Support for privatization has dropped from 46 percent of the population to 36 percent in May 2000. Most ominously of all, in the former communist nations capitalism has been found wanting, and men associated with old regimes stand poised to resume power. Some Americans sense too that one reason for their decade-long boom is that the more precarious the rest of the world looks, the more attractive American stocks and bonds become as a haven for international money.

In the business community of the West, there is a growing concern that the failure of most of the rest of the world to implement capitalism will eventually drive the rich economies into recession. As millions of investors have painfully learned from the evapora-

tion of their emerging market funds, globalization is a two-way street: If the Third World and former communist nations cannot escape the influence of the West, neither can the West disentangle itself from them. Adverse reactions to capitalism have also been growing stronger within rich countries themselves. The rioting in Seattle at the meeting of the World Trade Organization in December 1999 and a few months later at the IMF/World Bank meeting in Washington, D.C., regardless of the diversity of the grievances, highlighted the anger that spreading capitalism inspires. Many have begun recalling the economic historian Karl Polanyi's warnings that free markets can collide with society and lead to fascism. Japan is struggling through its most prolonged slump since the Great Depression. Western Europeans vote for politicians who promise them a "third way" that rejects what a French best-seller has labeled *L'Horreur économique*.

These whispers of alarm, disturbing though they are, have thus far only prompted American and European leaders to repeat to the rest of the world the same wearisome lectures: Stabilize your currencies, hang tough, ignore the food riots, and wait patiently for the foreign investors to return.

Foreign investment is, of course, a very good thing. The more of it, the better. Stable currencies are good, too, as are free trade and transparent banking practices and the privatization of state-owned industries and every other remedy in the Western pharmacopoeia. Yet we continually forget that global capitalism has been tried before. In Latin America, for example, reforms directed at creating capitalist systems have been tried at least four times since independence from Spain in the 1820s. Each time, after the initial euphoria, Latin Americans swung back from capitalist and market economy policies. These remedies are clearly not enough. Indeed, they fall so far short as to be almost irrelevant.

When these remedies fail, Westerners all too often respond not

by questioning the adequacy of the remedies but by blaming Third World peoples for their lack of entrepreneurial spirit or market orientation. If they have failed to prosper despite all the excellent advice, it is because something is the matter with them: They missed the Protestant Reformation, or they are crippled by the disabling legacy of colonial Europe, or their IQs are too low. But the suggestion that it is culture that explains the success of such diverse places as Japan, Switzerland, and California, and culture again that explains the relative poverty of such equally diverse places as China, Estonia, and Baja California, is worse than inhumane; it is unconvincing. The disparity of wealth between the West and the rest of the world is far too great to be explained by culture alone. Most people want the fruits of capital—so much so that many, from the children of Sanchez to Khrushchev's son, are flocking to Western nations.

The cities of the Third World and the former communist countries are teeming with entrepreneurs. You cannot walk through a Middle Eastern market, hike up to a Latin American village, or climb into a taxicab in Moscow without someone trying to make a deal with you. The inhabitants of these countries possess talent, enthusiasm, and an astonishing ability to wring a profit out of practically nothing. They can grasp and use modern technology. Otherwise, American businesses would not be struggling to control the unauthorized use of their patents abroad, nor would the U.S. government be striving so desperately to keep modern weapons technology out of the hands of Third World countries. Markets are an ancient and universal tradition: Christ drove the merchants out of the temple two thousand years ago, and Mexicans were taking their products to market long before Columbus reached America.

But if people in countries making the transition to capitalism are not pitiful beggars, are not helplessly trapped in obsolete ways,

and are not the uncritical prisoners of dysfunctional cultures, what is it that prevents capitalism from delivering to them the same wealth it has delivered to the West? Why does capitalism thrive only in the West, as if enclosed in a bell jar?

In this book I intend to demonstrate that the major stumbling block that keeps the rest of the world from benefiting from capitalism is its inability to produce capital. Capital is the force that raises the productivity of labor and creates the wealth of nations. It is the lifeblood of the capitalist system, the foundation of progress, and the one thing that the poor countries of the world cannot seem to produce for themselves, no matter how eagerly their people engage in all the other activities that characterize a capitalist economy.

I will also show, with the help of facts and figures that my research team and I have collected, block by block and farm by farm in Asia, Africa, the Middle East, and Latin America, that most of the poor already possess the assets they need to make a success of capitalism. Even in the poorest countries, the poor save. The value of savings among the poor is, in fact, immense—forty times all the foreign aid received throughout the world since 1945. In Egypt, for instance, the wealth that the poor have accumulated is worth fifty-five times as much as the sum of all direct foreign investment ever recorded there, including the Suez Canal and the Aswan Dam. In Haiti, the poorest nation in Latin America, the total assets of the poor are more than one hundred fifty times greater than all the foreign investment received since Haiti's independence from France in 1804. If the United States were to hike its foreign-aid budget to the level recommended by the United Nations—0.7 percent of national income—it would take the richest country on earth more than 150 years to transfer to the world's poor resources equal to those they already possess.

But they hold these resources in defective forms: houses built on

land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, industries located where financiers and investors cannot see them. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment.

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

Third World and former communist nations do not have this representational process. As a result, most of them are undercapitalized, in the same way that a firm is undercapitalized when it issues fewer securities than its income and assets would justify. The enterprises of the poor are very much like corporations that cannot issue shares or bonds to obtain new investment and finance. Without representations, their assets are dead capital.

The poor inhabitants of these nations—five-sixths of humanity—do have things, but they lack the process to represent their property

and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. It is the unavailability of these essential representations that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.

This is the mystery of capital. Solving it requires an understanding of why Westerners, by representing assets with titles, are able to see and draw out capital from them. One of the greatest challenges to the human mind is to comprehend and to gain access to those things we know exist but cannot see. Not everything that is real and useful is tangible and visible. Time, for example, is real, but it can only be efficiently managed when it is represented by a clock or a calendar. Throughout history, human beings have invented representational systems—writing, musical notation, double-entry bookkeeping—to grasp with the mind what human hands could never touch. In the same way, the great practitioners of capitalism, from the creators of integrated title systems and corporate stock to Michael Milken, were able to reveal and extract capital where others saw only junk by devising new ways to represent the invisible potential that is locked up in the assets we accumulate.

At this very moment you are surrounded by waves of Ukrainian, Chinese, and Brazilian television that you cannot see. So, too, are you surrounded by assets that invisibly harbor capital. Just as the waves of Ukrainian television are far too weak for you to sense them directly but can, with the help of a television set, be decoded to be seen and heard, so can capital be extracted and processed from assets. But only the West has the conversion process required to transform the invisible to the visible. It is *this* disparity that explains why Western nations can create capital and the Third World and former communist nations cannot.

The absence of this process in the poorer regions of the

## CHAPTER THREE

# 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 many 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 not unlike 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: Although 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 percent 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.

### 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 preeminent factor (as the capital issues in such phrases as *capital* importance, *capital* punishment, the *capital* city of a country). What they wanted to understand was 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 labor theory of value has no practical application), there is 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 labor 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 that 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, pastoral, and agricultural society to a commercial one where, through mutual 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."<sup>1</sup>

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."<sup>2</sup> Smith warned that labor 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."<sup>3</sup> 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."<sup>4</sup> 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."<sup>5</sup>

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."<sup>6</sup> 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."<sup>7</sup>

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. In fact, 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 can 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 hydroelec-

tric 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 can then rotate turbines, creating mechanical energy that can 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 can be further transmitted through wire conductors to faraway places to deploy new production.

Thus an apparently placid lake can be used to light your room and power the machinery in a factory. What was required was an external man-made process that 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, which can then 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 actively *thinking* about them as they could be. It requires a process for fixing an asset’s economic potential into a form that can be used to initiate additional production.

Although 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 neighbors. This is often the only way to verify that the owner actually owns the house and there are no other claims on it. It is also why the exchange of most assets outside the West is restricted to local circles of trading partners.

As we 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 past forty years. What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market. 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 electrical energy, 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 actually 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 better understand 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."<sup>8</sup> 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 the Third World and in 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 in 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 it represents.

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 nonvisible 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 can be secured by liens, mortgages, easements, and other covenants).

In advanced nations, this formal property representation func-

tions 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; and as a liable terminal for receiving public utility services, such as energy, water, sewage, telephone, or cable services. 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 also 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.

## CHAPTER SIX

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# The Mystery of Legal Failure

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

—U.S. Supreme Court Justice Oliver Wendell Holmes

NEARLY EVERY developing and former communist nation has a formal property system. The problem is that most 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 operate under five basic misconceptions:

- all people who take cover in the extralegal or underground sectors do so to avoid paying taxes;
- real estate assets are not held legally because they have not been properly surveyed, mapped, and recorded;
- enacting mandatory law on property is sufficient, and governments can ignore the costs of compliance with that law;
- existing extralegal arrangements or “social contracts” can be ignored;
- 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 typically 50 to 80 percent of the people 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 totaled US\$1.2 billion.

We were successful because we modified company and property law to adapt to the needs of entrepreneurs accustomed to extralegal rules. We also cut dramatically the costs of the red tape to enroll 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 program, 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 neighbors 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 percent 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 cannot openly advertise to build up their clientele or make less costly bulk deliveries to customers.

Our research in the countries we have worked with has confirmed that 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 geographic 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 World War II 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 but of 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 elites 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 behavior: 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 power 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.<sup>1</sup>

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.

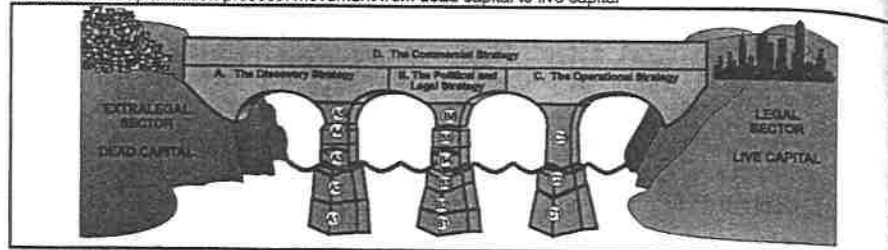
Does that mean that lawyers should lead the integration process? No. Implementing major legal change is a political responsibility. There are various reasons for this. First, law is generally concerned with protecting property rights. However, the real task in developing and former communist countries 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 repre-

sented by the countries' best commercial lawyers—are likely to oppose change unless they are convinced otherwise. Bringing well-connected and moneyed people onto 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 grass roots, 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 policymakers, 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

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 equating 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 services**

are assisting various governments throughout the world. The formula is outlined in 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 the Institute of Liberty and Democracy archives. In the rest of this chapter I will focus on the two indispensable components of the formula: the legal challenge and the political challenge.

## 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 neighbors. 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 percent of Indonesians who live in the extralegal sector. Fearing that I would lose my audience if I went into a drawn-out technical explanation on how to structure a bridge between the extralegal and legal sectors, I came up with another way, an Indonesian way, to answer their question. During my book tour, I

had taken a few days off to visit Bali, one of the most beautiful places on earth. As I strolled through rice fields, I had no idea where the property boundaries were. But the dogs knew. Every time I crossed from one farm to another, a different dog barked. Those Indonesian dogs may have been ignorant of formal law, but they were positive about which assets their masters controlled.

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

Discovering "the people's law" is how Western nations built their formal property systems. Any government that is serious about reengineering the ruling informal agreements into one national formal property social contract needs to listen to its barking dogs. To integrate all forms of property into a unified system, governments must find out how and why the local conventions work and how strong they actually are.

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 behavior; they are also arrangements that are explicitly documented by real people. As a result, these extralegal social contracts can actually 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 Precapitalist 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 labor 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.<sup>2</sup> As C. Reinold Noyes has pointed out:

Human nature demands regularity and certainty and this demand requires that these primitive judgments 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.<sup>3</sup>

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

ers 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 to 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.<sup>14</sup>

“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 toward 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 honor 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 get good educations and become computer literate.) It is inevitable that individual extralegal social contracts in the same country will be more alike than different.<sup>15</sup>

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, landholders 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 draw upon. 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.<sup>16</sup>

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 center 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

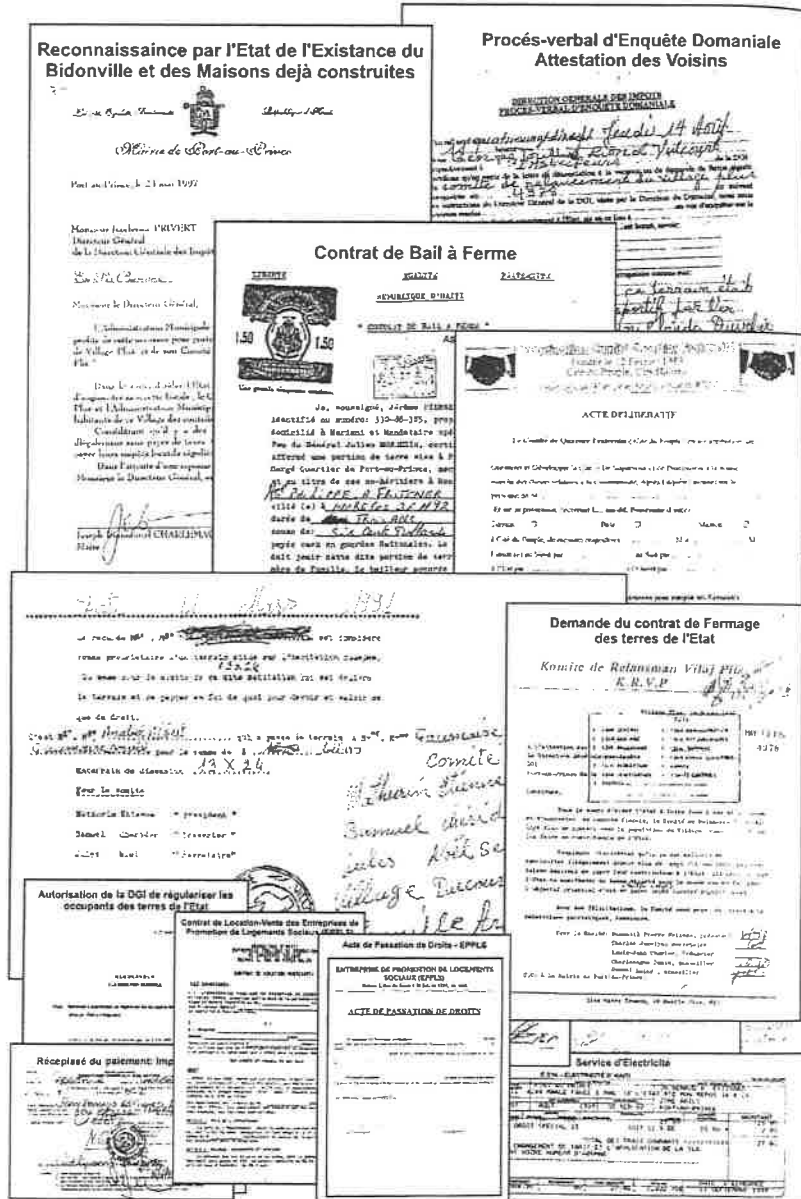
each leaf back in time from twig and branch to the trunk and finally to the roots. The approach to extralegal property has to be synchronic: The only way an outsider can determine which rights belong to whom is by slicing the tree at right angles to the trunk so as to define the status of each branch and leaf in relation to its neighbors.

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 percent 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 Haitian informal titles). Everywhere we have been in the world, most informals have some physical artifact 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.

Although 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

FIGURE 6.2 Proofs of Ownership used by informals in Haiti



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. Representations are the result of a specific group of people having reached a respected consensus as to who owns what property and what each owner may do with it. Reading representations themselves and extracting meaning from them does not require a degree in archaeology. They contain no mysterious codes to be deciphered. People with very straightforward, business-like intentions have written these documents to make absolutely clear to all concerned what rights they claim to have over the specific assets they control. They *want* to communicate the legitimacy of their rights and are prepared to provide as much supporting evidence as possible. Their representations have nothing to hide; they have been designed to be recognizable for what they are. This is not always so obvious because, regrettably, when dealing with the poor we tend to confuse the lack of a centralized record-keeping facility with ignorance. 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.<sup>17</sup>

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. In fact, it is not much different from government procedures to make legal texts uniform within countries (such as the U.S. Unified Commercial Code) or between countries at an international level (such as the many integrated mandatory codes produced by the European Union or the World Trade Organization). By comparing the extralegal to the legal codes, government leaders can see how both have to be adjusted to fit each other and then build a regulatory framework for property—a common bedrock of law for all citizens—that is genuinely legitimate and self-enforceable because it reflects both legal and extralegal reality. That is the way for developing and former communist nations to meet the legal challenge, and that 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 required to integrate the poor and their possessions into a legal framework, so that they can 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 they were armed with astutely aimed legislation that permitted government to create popularly supported, bloodless revolutions that could not be halted.

Why do you need a political strategy today? Who could possibly