"The blueprint for a new industrial revolution."
—THE TIMES (LONDON)

THE MYSTERY OF CAPITAL

WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE

HERNANDO DE SOTO

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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CHAPTER TWO

The Mystery of Missing Information

Economics, over the years, has become more and more abstract and divorced from events in the real world. Economists, by and large, do not study the workings of the actual economic system. They theorize about it. As Ely Devons, an English economist, once said at a meeting, "If economists wished to study the horse, they wouldn't go and look at horses. They'd sit in their studies and say to themselves, 'What would I do if I were a horse?'"

—Ronald H. Coase, *The Task of the Society*

IMAGINE a country where nobody can identify who owns what, addresses cannot be easily verified, people cannot be made to pay their debts, resources cannot conveniently be turned into money, ownership cannot be divided into shares, descriptions of assets are not standardized and cannot be easily compared, and the rules that govern property vary from neighborhood to neighborhood or even from street to street. You have just put yourself into the life of a developing country or former communist nation; more precisely, you have imagined life for 80 percent of its population, which is marked off as sharply from its Westernized elite as black and white South Africans were once separated by apartheid.

This 80 percent majority is not, as Westerners often imagine, desperately impoverished. In spite of their obvious poverty, even those who live under the most grossly unequal regimes possess far more than anybody has ever understood. What they possess, however, is not represented in such a way as to produce additional value. When you step out the door of the Nile Hilton, what you are leaving behind is not the high-technology world of fax machines and ice makers, television and antibiotics. The people of Cairo have access to all those things.

What you are really leaving behind is the world of legally enforceable transactions on property rights. Mortgages and accountable addresses to generate additional wealth are unavailable even to those people in Cairo who would probably strike you as quite rich. Outside Cairo, some of the poorest of the poor live in a district of old tombs called "the city of the dead." But almost all of Cairo is a city of the dead—of dead capital, of assets that cannot be used to their fullest. The institutions that give life to capital—that allow one to secure the interests of third parties with work and assets—do not exist here.

To understand how this is possible, one must look to the nineteenth century, when the United States was carving a society out of its own wilderness. The United States had inherited from Britain not only its fantastically complex land law but also a vast system of overlapping land grants. The same acre might belong to one man who had received it as part of a vast land grant from the British Crown, to another who claimed to have bought it from an Indian tribe, and to a third who had accepted it in place of salary from a state legislature—and none of the three might ever have actually laid eyes on it. Meanwhile, the country was filling up with immigrants, who settled boundaries, ploughed fields, built homes, transferred land, and established credit long before governments conferred on them any right to engage in these acts. Those were the days of the pioneers and the "Wild West." One of the reasons it was so wild was that those pioneers, most of them nothing but squatters, "insisted that their labor, not formal paper titles or arbitrary boundary lines, gave land value and established ownership."[1] They believed that if they occupied the land and improved it with houses and farms, it was theirs. State and federal governments believed otherwise. Officials sent in troops to burn farms and destroy buildings. Settlers fought back. When the soldiers left, the settlers rebuilt and returned to scratching out a living. That past is the Third World's present.

A Surprise Revolution

Before 1950, most Third World countries were agricultural societies organized in ways that would have made an eighteenth-century European feel right at home. Most people worked on the land, which was owned by a very few big landlords, some of them indigenous oligarchs, others colonial planters. Cities were small and functioned as markets and ports rather than industrial centers; they were dominated by tiny mercantile elites who protected their interests with thick wrappings of rules and regulations.

After 1950, there began in the Third World an economic revolution similar to the social and economic disruptions in Europe in 1800. New machines were reducing the demand for rural labor just as new medicines and public-health methods were cutting the rate of infant mortality and extending life spans. Soon hundreds of thousands of people were trundling down the newly built highways to the cities so alluringly described in the new radio programs.

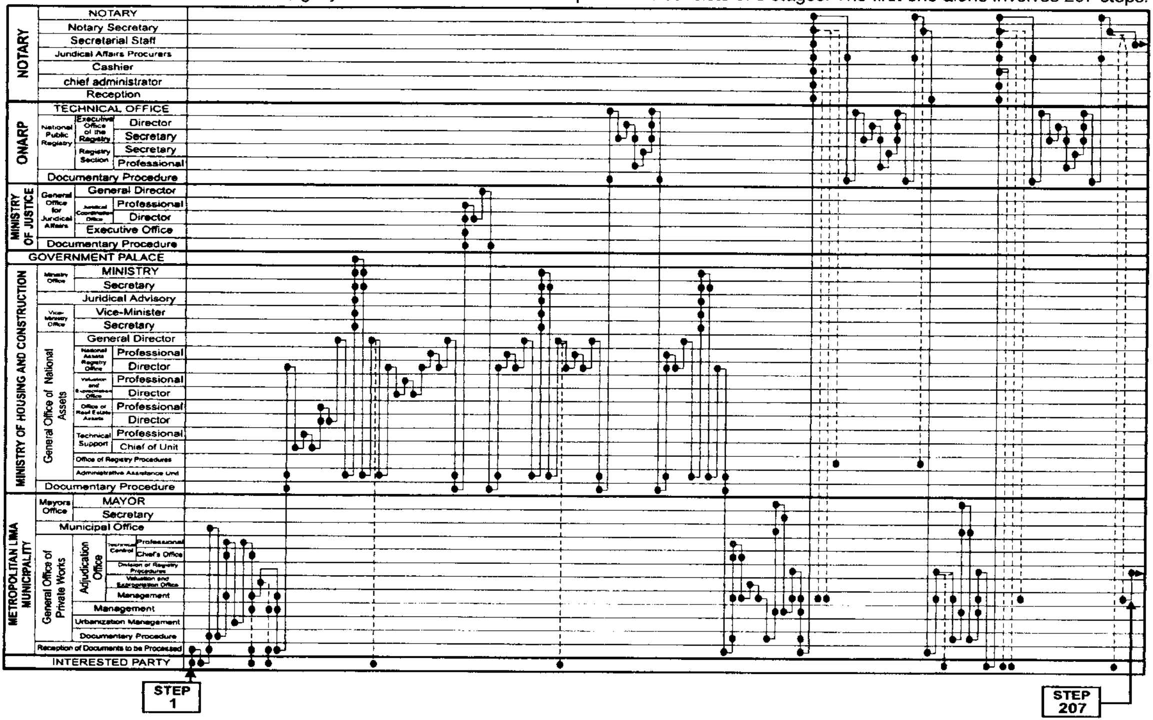
The population of the cities began to rise rapidly. In China alone, more than 100 million people have moved from the countryside to the cities since 1979. Between 1950 and 1988, the population of metropolitan Port-au-Prince rose from 140,000 to 1,550,000. By 1998, it was approaching 2 million. Almost two-thirds of these people live in shantytowns. Experts were already in despair over this surge of new city dwellers as early as 1973, long before the largest influx had taken place. "Everything happens as if the city were falling apart," wrote one urbanist. "Uncontrolled construction, anywhere anyhow. The sewage system is incapable of helping drain rainwater and stuffs up every day. The population concentrates in defined areas where no sanitation infrastructure is provided.... The sidewalks of the Avenue Dessalines are literally occupied by small vendors.... This town has become unlivable."[2]

Few had anticipated this enormous transformation in the way people lived and worked. The fashionable theories of the day about "development" sought to bring modernity to the countryside. Peasants were not supposed to come to the cities looking for the twentieth century. But tens of millions came anyway, despite a backlash of mounting hostility. They faced an impenetrable wall of rules that barred them from legally established social and economic activities. It was tremendously difficult for these new city people to acquire legal housing, enter formal business, or find a legal job.

The Obstacles to Legality

To get an idea of just how difficult the migrant's life was, my research team and I opened a small garment workshop on the outskirts of Lima, Peru. Our goal was to create a new and perfectly legal business. The team then began filling out the forms, standing in the lines, and making the bus trips into central Lima to get all the certifications required to operate, according to the letter of the law, a small business in Peru. They spent six hours a day at it and finally registered the business—289 days later. Although the garment workshop was geared to operating with only one worker, the

FIGURE 2.1 Procedure to form a legally obtained home in Peru. The procedure consists of 5 stages. The first one alone involves 207 steps.



cost of legal registration was $1,231—thirty-one times the monthly minimum wage. To obtain legal authorization to build a house on state-owned land took six years and eleven months, requiring 207 administrative steps in fifty-two government offices (see Figure 2.1). To obtain a legal title for that piece of land took 728 steps. We also found that a private bus, jitney, or taxi driver who wanted to obtain official recognition of his route faced twenty-six months of red tape.

My research team, with the help of local associates, has repeated similar experiments in other countries. The obstacles were no less formidable than in Peru; often they were even more daunting. In the Philippines, if a person has built a dwelling in a settlement on either state-owned or privately owned urban land, to purchase it legally he would have to form an association with his neighbors in order to qualify for a state housing finance program. The entire process could necessitate 168 steps, involving fifty-three public and private agencies and taking thirteen to twenty-five years (see Figure 2.2). And that assumes the state housing finance program has sufficient funds. If the dwelling happens to be in an area still considered "agricultural," the settler will have to clear additional hurdles for converting that land to urban use—45 additional bureaucratic procedures before thirteen entities, adding another two years to his quest.

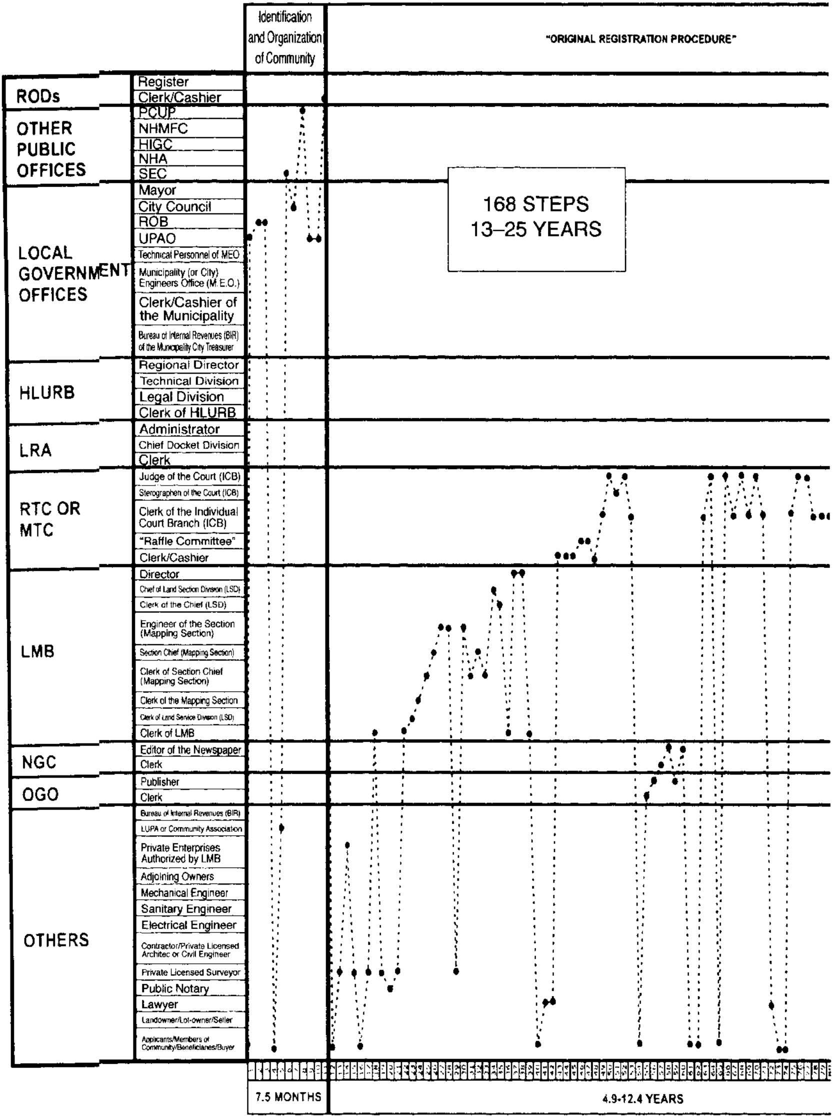
In Egypt, the person who wants to acquire and legally register a lot on state-owned desert land must wend his way through at least 77 bureaucratic procedures at thirty-one public and private agencies (see Figure 2.3). This can take anywhere from five to fourteen years. To build a legal dwelling on former agricultural land would require six to eleven years of bureaucratic wrangling, maybe longer. This explains why 4.7 million Egyptians have chosen to build their dwellings illegally. If after building his home, a settler decides he would now like to be a law-abiding citizen and purchase the rights to his dwelling, he risks having it demolished, paying a steep fine, and serving up to ten years in prison.

In Haiti, one way an ordinary citizen can settle legally on government land is first to lease it from the government for five years and then buy it. Working with associates in Haiti, our researchers found that to obtain such a lease took 65 bureaucratic steps—requiring, on average, a little more than two years—all for the privilege of merely leasing the land for five years. To buy the land required another 111 bureaucratic hurdles—and twelve more years (See Figure 2.4). Total time to gain lawful land in Haiti: nineteen years. Yet even this long ordeal will not ensure that the property remains legal.

In fact, in every country we investigated, we found that it is very nearly as difficult to *stay* legal as it is to *become* legal. Inevitably, migrants do not so much break the law as the law breaks them—and they opt out of the system. In 1976, two-thirds of those who worked in Venezuela were employed in legally established enterprises; today the proportion is less than half. Thirty years ago, more than two-thirds of the new housing erected in Brazil was intended for rent. Today, only about 3 percent of new construction is officially listed as rental housing. To where did that market vanish? To the extralegal areas of Brazilian cities called *favelas*, which operate outside the highly regulated formal economy and function according to supply and demand. There are no rent controls in the *favelas;* rents are paid in U.S. dollars, and renters who do not pay are rapidly evacuated.

Once these newcomers to the city quit the system, they become "extralegal." Their only alternative is to live and work outside the official law, using their own informally binding arrangements to protect and mobilize their assets. These arrangements result from a combination of rules selectively borrowed from the official legal system, ad hoc improvisations, and customs brought from their

FIGURE 2.2 Procedure to formalize informal urban property in the Philippines



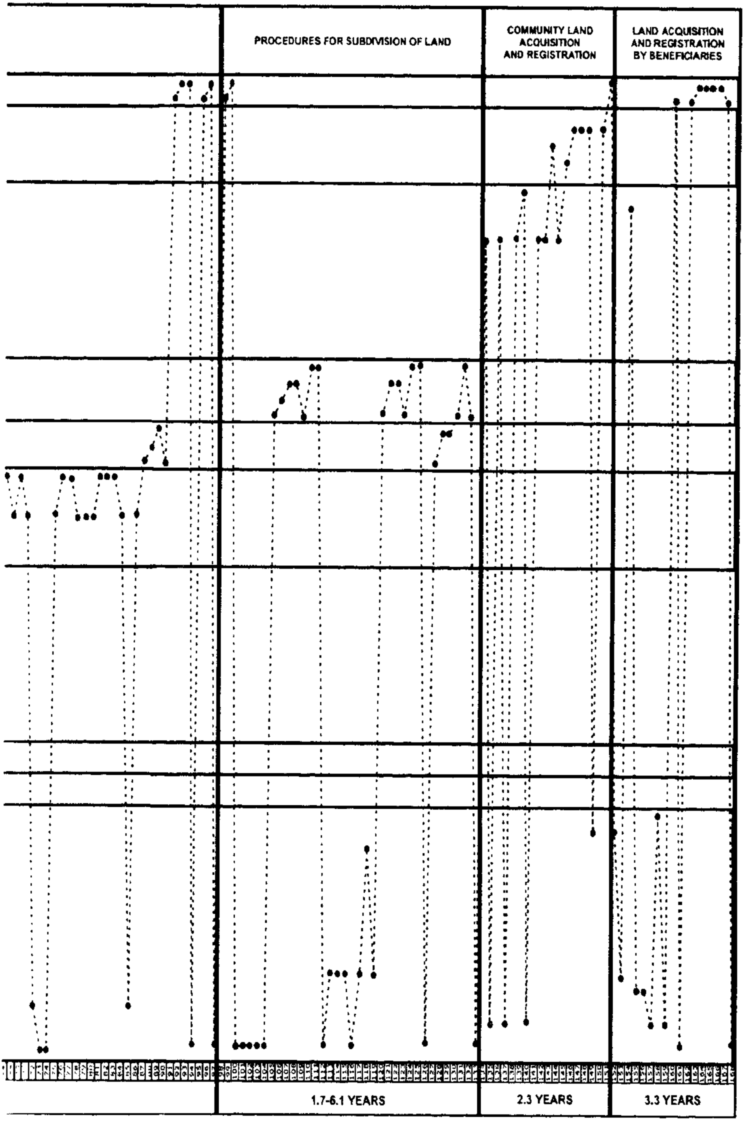
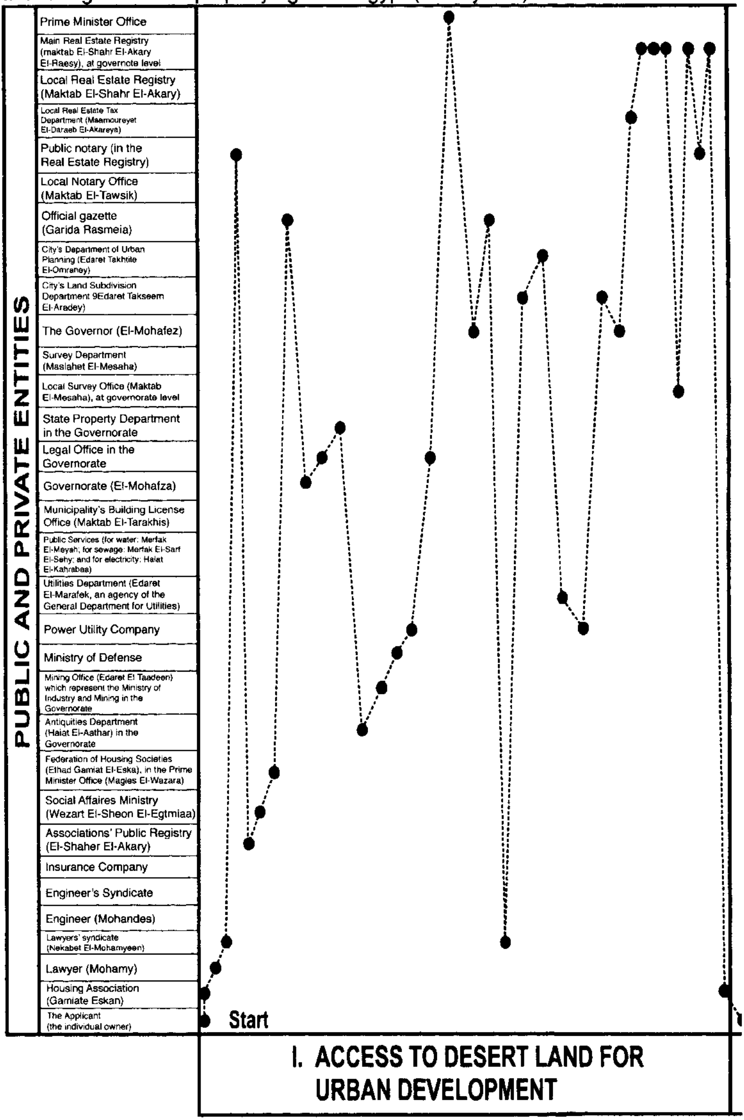
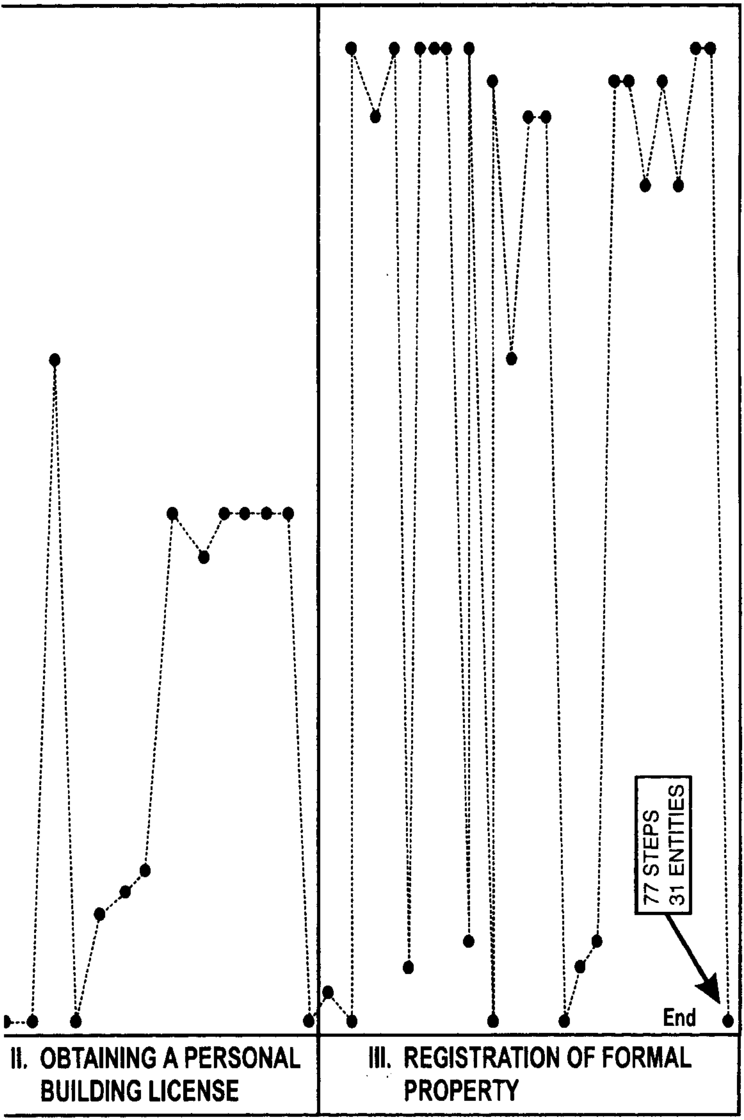

PROCEDURES FOR SUBDIVISION OF LAND
COMMUNITY LAND ACQUISITION AND REGISTRATION
LAND ACQUISITION AND REGISTRATION BY BENEFICIARIES
1.7-6.1 YEARS
2.3 YEARS
3.3 YEARS

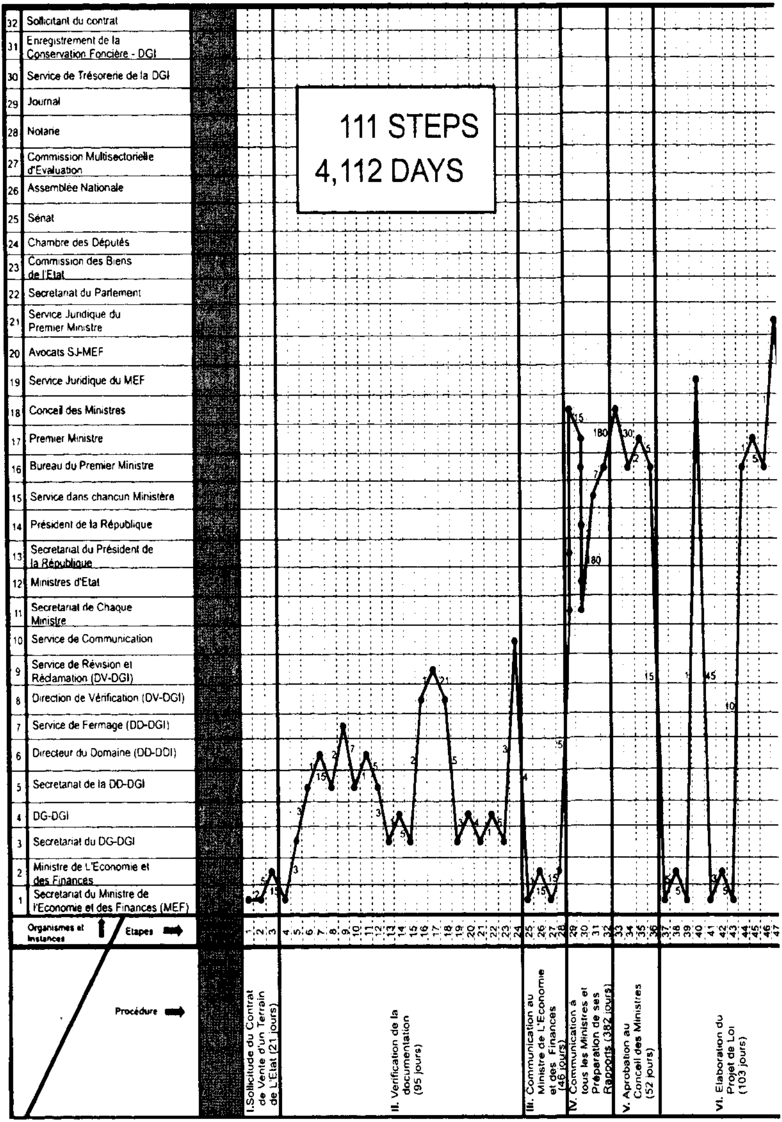
FIGURE 2.3 Procedure to gain access to desert land for construction purposes and to register these property rights in Egypt (6–14 years)

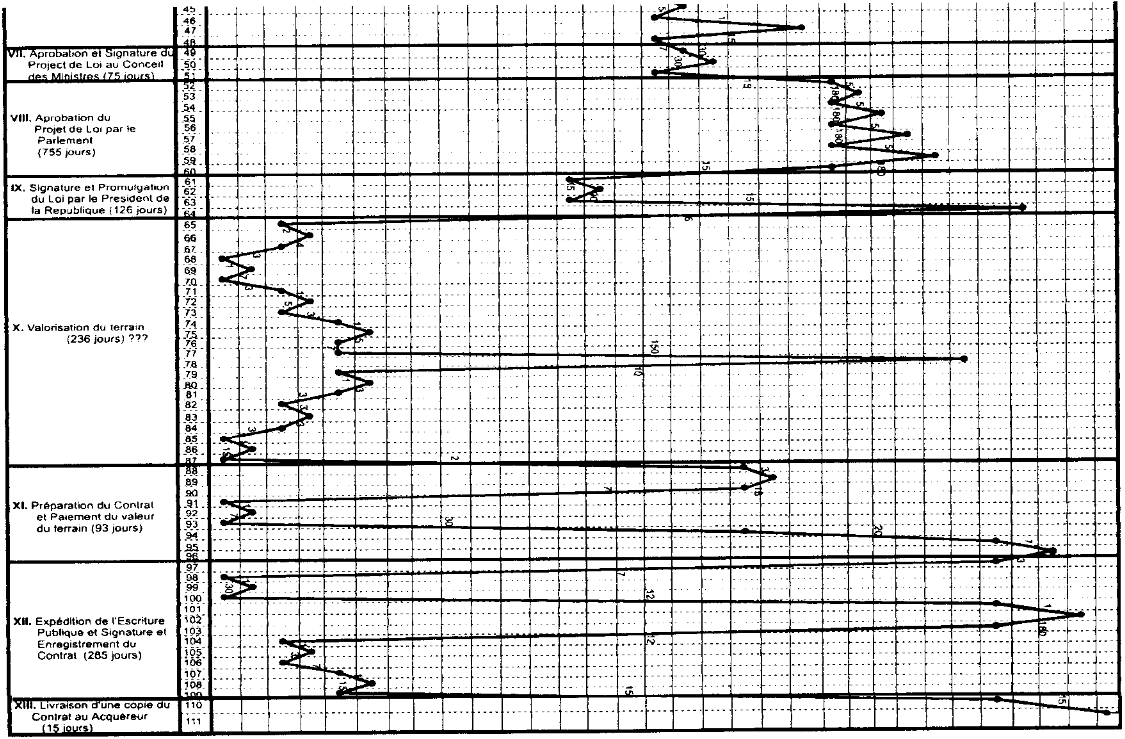




77 STEPS
31 ENTITIES
End
II. OBTAINING A PERSONAL BUILDING LICENSE
III. REGISTRATION OF FORMAL PROPERTY

FIGURE 2.4 Procedure to obtain a sales (vente) contract following the five-year lease contract in Haiti




VII. Aprobation et Signature du Project de Loi au Conceil des Ministres (75 jours)
VIII. Aprobation du Projet de Loi par le Parlement (755 jours)
IX. Signature et Promulgation du Loi par le President de la Republique (126 jours)
X. Valorisation du terrain (236 jours) ???
XI. Préparation du Contrat et Paiement du valeur du terrain (93 jours)
XII. Expédition de l'Escriture Publique et Signature et Enregistrement du Contrat (285 jours)
XIII. Livraison d'une copie du Contrat au Acquéreur (15 jours)

places of origin or locally devised. They are held together by a social contract that is upheld by a community as a whole and enforced by authorities the community has selected. These extralegal social contracts have created a vibrant but undercapitalized sector, the center of the world of the poor.

The Undercapitalized Sector

Although the migrants are refugees from the law, they have hardly retreated into idleness. Undercapitalized sectors throughout the Third World and in former communist countries buzz with hard work and ingenuity. Street-side cottage industries have sprung up everywhere, manufacturing anything from clothing and footwear to imitation Cartier watches and Vuitton bags. There are workshops that build and rebuild machinery, cars, even buses. The new urban poor have created entire industries and neighborhoods that have to operate on clandestine connections to electricity and water. There are even dentists who fill cavities without a license.

This is not just a story of the poor serving the poor. These new entrepreneurs are filling the gaps in the legal economy as well. Unauthorized buses, jitneys, and taxis account for most of the public transportation in many developing countries. In other parts of the Third World, vendors from the shantytowns supply most of the food available in the market, whether from carts on the street or from stalls in buildings they construct.

In 1993, the Mexican Chamber of Commerce estimated the number of street-vendor stands in the Federal District of Mexico City at 150,000, with an additional 293,000 in forty-three other Mexican centers. These tiny booths average just 1.5 meters wide. If the Mexico City vendors lined up their stands on a single street with no gaps at intersections, they would form a continuous row more than 210 kilometers long. Thousands upon thousands of people work in the extralegal sector—on the streets, from their homes, and in the city's unregistered shops, offices, and factories. An attempt by the Mexican National Statistics Institute in 1994 to measure the number of informal "microbusinesses" in the entire country came up with a total of 2.65 million.

These are all real-life examples of economic life in the undercapitalized sector of society. In the former communist nations, you may see even more sophisticated activities off the books, from the production of computer hardware and software to the manufacture of jet fighters for sale abroad.

Russia, of course, has quite a different history from Third World countries such as Haiti and the Philippines. Nevertheless, since the fall of communism, the former Soviet states have been slipping into the same patterns of informal ownership. In 1995, *Business Week* reported that four years after the end of communism, only "some 280,000 farmers out of 10 million own their land" in Russia. Another report paints a familiar Third World picture: "[In the former Soviet Union], rights of private possession, use, and alienation of land are inadequately defined and not clearly protected by law.... Mechanisms used in market economies to protect land rights are still in their infancy.... The State itself continues to restrict use rights on land that it does not own."[3] Estimates based on electricity consumption indicate that between 1989 and 1994, unofficial activity in former Soviet states increased from 12 percent to 37 percent of total production. Some put the proportion even higher.

None of this will come as news to those who live outside the West. You need only open a window or take a taxi from the airport to your hotel to see city perimeters crowded with homes, armies of vendors hawking wares in the streets, glimpses of bustling workshops behind garage doors, and battered busses crisscrossing the grimy streets. Extralegality is often perceived as a "marginal" issue similar to black markets in advanced nations, or poverty, or unemployment. The extralegal world is typically viewed as a place where gangsters roam, sinister characters of interest only to the police, anthropologists, and missionaries.

In fact it is legality that is marginal; extralegality has become the norm. The poor have already taken control of vast quantities of real estate and production. Those international agencies that jet their consultants to the gleaming glass towers of the elegant quadrants of town to meet with the local "private sector" are talking to only a fraction of the entrepreneurial world. The emerging economic powers of the Third World and former communist nations are the garbage collectors, the appliance manufacturers, and the illegal construction companies in the streets far below. The only real choice for the governments of these nations is whether they are going to integrate those resources into an orderly and coherent legal framework or continue to live in anarchy.

How Much Dead Capital?

Over the past decade my researchers, assisted by knowledgeable local professionals, have made surveys of five Third World cities—Cairo, Lima, Manila, Mexico City, and Port-au-Prince—in an effort to gauge the value of the possessions of those people who have been locked out of the capitalized economy by discriminatory laws. (These results are graphically summarized in the charts in the Appendix, pp. 251–254.) To be more confident of our results, we focused our attention on the most tangible and detectable of assets: real estate.

Unlike the sale of food or shoes, auto repair, or the manufacture of phony Cartier watches—activities that are difficult to count and even more difficult to value—buildings cannot be hidden. You can ascertain their value simply by surveying the cost of the building materials and observing the selling prices of comparable buildings. We spent many thousands of days counting buildings block by block. Wherever authorized to do so, we published our results obtained in each country, so that they could be openly discussed and criticized. In collaboration with people on the spot, we tested and retested our methods and results.

We discovered that the way the people build in the undercapitalized sector takes as many forms as there are legal obstacles to circumvent. The most obvious form is the shanty built on government-owned land. But our researchers discovered far more creative ways of getting around the real estate laws. In Peru, for instance, people formed agricultural cooperatives to buy estates from their old owners and to convert them into housing and industrial settlements. Because there are no easy legal ways to change land tenure, farmers in state-owned cooperatives illegally subdivided the land into smaller, privately held parcels. As a result, few if any have valid title to their ground. In Port-au-Prince, even quite expensive properties change hands without anybody bothering to inform the registry office, which is hopelessly backlogged anyway. In Manila, housing springs up on land zoned solely for industrial use. In Cairo, residents of older four-story public housing projects build three illegal stories on top of their buildings and sell the apartments to relatives and other clients. Also in Cairo, the legal tenants of apartments whose rents were frozen in the early 1950s at sums now worth less than a dollar a year subdivide these properties into smaller apartments and lease them out at market prices.

Some of this housing was extralegal from day one, constructed in violation of all kinds of laws. Other buildings—the Port-au-Prince houses, the Cairo rent-controlled apartments—originated in the legal system but then dropped out as complying with the law became too costly and complicated. By one route or another, almost every dwelling place in the cities we surveyed exited the legal framework—and the very laws that could have hypothetically provided owners with the representations and institutions to create capital. There still may be deeds or some kind of record in someone's hands, but the real ownership status of these assets has slipped out of the official registry system, leaving records and maps outdated.

The result is that most people's resources are commercially and financially invisible. Nobody really knows who owns what or where, who is accountable for the performance of obligations, who is responsible for losses and fraud, or what mechanisms are available to enforce payment for services and goods delivered. Consequently, most potential assets in these countries have not been identified or realized; there is little accessible capital, and the exchange economy is constrained and sluggish.

This picture of the undercapitalized sector is strikingly different from the conventional wisdom of the developing world. But this is where most people live. It is a world where ownership of assets is difficult to trace and validate and is governed by no legally recognizable set of rules; where the assets' potentially useful economic attributes have not been described or organized; where they cannot be used to obtain surplus value through multiple transactions because their unfixed nature and uncertainty leave too much room for misunderstanding, faulty recollection, and reversal of agreement—where most assets, in short, are dead capital.

How Much Is This Dead Capital Worth?

Dead capital, virtual mountains of it, lines the streets of every developing and former communist country. In the Philippines, by our calculation, 57 percent of city dwellers and 67 percent of people in the countryside live in housing that is dead capital. In Peru, 53 percent of city dwellers and 81 percent of people in the countryside live in extralegal dwellings.

The figures are even more dramatic in Haiti and Egypt. In Haiti, also according to our surveys, 68 percent of city dwellers and 97 percent of people in the countryside live in housing to which nobody has clear legal title. In Egypt, dead-capital housing is home for 92 percent of city dwellers and 83 percent of people in the countryside.

Many of these dwellings are not worth much by Western standards. A shanty in Port-au-Prince may fetch as little as $500, a cabin by a polluted waterway in Manila only $2,700, a fairly substantial house in a village outside Cairo only about $5,000, and in the hills around Lima, a respectable bungalow with a garage and picture windows is valued at only $20,000. But there are a great many such dwellings, and collectively their value dramatically outweighs the total wealth of the rich.

In Haiti, untitled rural and urban real estate holdings are together worth some $5.2 billion. To put that sum in context, it is four times the total of all the assets of all the legally operating companies in Haiti, nine times the value of all assets owned by the government, and 158 times the value of all foreign direct investment in Haiti's recorded history to 1995. Is Haiti an exception, a part of Francophone Africa mistakenly put into the American hemisphere, where the Duvalier regime delayed the emergence of a systematized legal system? Perhaps.

Then let's consider Peru, a Hispanic and Indo-American country with a very different tradition and ethnic makeup. The value of extralegally held rural and urban real estate in Peru amounts to some $74 billion. This is five times the total valuation of the Lima Stock Exchange before the slump of 1998, eleven times greater than the value of potentially privatizable government enterprises and facilities, and fourteen times the value of all foreign direct investment in the country through its documented history. Would you counter that Peru's formal economy has also been stunted by the traditions of the ancient Inca Empire, the corrupting influence of colonial Spain, and the recent war with the Maoist Sendero Luminoso?

Very well, then consider the Philippines, a former Asian protectorate of the United States. The value of untitled real estate there is $133 billion, four times the capitalization of the 216 domestic companies listed on the Philippines Stock Exchange, seven times the total deposits in the country's commercial banks, nine times the total capital of state-owned enterprises, and fourteen times the value of all foreign direct investment.

Perhaps the Philippines, too, is an anomaly—something to do with how Christianity developed in former Spanish colonies. If so, let's consider Egypt. The value of Egypt's dead capital in real estate is, by the tally we made with our Egyptian colleagues, some $240 billion. That is thirty times the value of all the shares on the Cairo Stock Exchange and, as I mentioned previously, fifty-five times the value of all foreign investment in Egypt.

In every country we have examined, the entrepreneurial ingenuity of the poor has created wealth on a vast scale—wealth that also constitutes by far the largest source of potential capital for development. These assets not only far exceed the holdings of the government, the local stock exchanges, and foreign direct investment; they are many times greater than all the aid from advanced nations and all the loans extended by the World Bank.

The results are even more astonishing when we take the data from the four countries we have studied and project it over the Third World and former communist nations as a whole. We estimate that about 85 percent of urban parcels in these nations, and between 40 percent and 53 percent of rural parcels, are held in such a way that they cannot be used to create capital. Putting a value on all these assets is inevitably going to come up with a rough number. But we believe that our estimates are as accurate as they can be and quite conservative.

By our calculations, the total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least $9.3 trillion (see Table 2.1).

This is a number worth pondering: $9.3 trillion is about twice as much as the total circulating U.S. money supply. It is very nearly as much as the total value of all the companies listed on the main stock exchanges of the world's twenty most developed countries: New York, Tokyo, London, Frankfurt, Toronto, Paris, Milan, the NASDAQ, and a dozen others. It is more than twenty times the total direct foreign investment into all Third World and former communist countries in the ten years after 1989, forty-six times as much as all the World Bank loans of the past three decades, and ninety-three times as much as all development assistance from all advanced countries to the Third World in the same period.

Acres of Diamonds

The words "international poverty" too easily bring to mind images of destitute beggars sleeping on the curbs of Calcutta and hungry African children starving on the sand. These scenes are of course real, and millions of our fellow human beings demand and deserve our help. Nevertheless, the grimmest picture of the Third World is not the most accurate. Worse, it draws attention away from the arduous achievements of those small entrepreneurs who have triumphed over every imaginable obstacle to create the greater part of the wealth of their society. A truer image would

TABLE 2.1 Urban and Rural Dead Capital in Real Estate Worldwide[1] (1997)

Urban

	Total Population (millions)	Urban Population (%)	Urban Population (millions)	Urban Dwellings (millions)	Informal Urban Dwellings[2] (millions)	Value of Informal Urban Dwellings (trillion US$)
Asia	1,747	29%	503	101	85	1.75
Africa	525	32%	167	33	28	0.58
Middle East & North Africa	371	57%	211	42	36	0.74
South America	328	78%	256	51	44	0.89
Mexico, Central America, and the Carribean	161	64%	103	21	18	0.36
China, NIS, and Eastern Europe	1,611	38%	619	124	105	2.16
Subtotal	4,743		1,859	372	316	6.48
Other Developing Countries	191	39%	75	15	13	0.26
TOTAL	4,934		1,934	387	329	6.74

Rural

	Rural Area (thousand ha)	Informality in Rural Area (%)	Informal Rural Area (thousand ha)	Informal Rural Area: Croplands (thousand ha)	Informal Rural Area: Graslands (thousand ha)	Value of Informal Rural Area[3] (trillion US$)
Asia	489,586	44%	215,164	147,798	67,365	0.59
Africa	738,639	50%	368,792	88,166	280,626	0.39
Middle East & North Africa	444,665	40%	177,866	59,660	118,206	0.25
South America	607,407	49%	297,895	51,006	246,889	0.24
Mexico, Central America, and the Carribean	134,541	53%	71,025	20,813	50,212	0.09
China, NIS, and Eastern Europe	1,151,280	47%	540,142	188,721	351,421	0.80
Subtotal	3,566,118		1,670,884	556,164	1,114,719	2.36
Other Developing Countries	359,926	47%	169,165	56,308	112,857	0.24
TOTAL	3,926,044		1,840,049	612,472	1,227,576	2.60
					Total Informal	**US $ 9.34 trillion**

[1]179 developing and former communist nations.
[2]It is estimated that 85% of urban parcels is informal. They either: I) were built in violation of express laws; II) did not comply with requirements for access to land; III) were originally formal but became informal; or IV) were built by the government without complying with legal requirements.
[3]A value of US$ 3,973 per hectare of croplands and of US$ 138 per hectare of grasslands were used.

depict a man and woman who have painstakingly saved to construct a house for themselves and their children and who are creating enterprises where nobody imagined they could be built. I resent the characterization of such heroic entrepreneurs as contributors to the problem of global poverty.

They are not the problem. They are the solution.

In the years after the American Civil War, a lecturer named Russell Conwell crisscrossed America delivering a message that stirred millions of people. He told the story of an Indian merchant who had been promised by a prophet that he would surely become rich beyond all imagining if only he would seek his treasure. The merchant traveled the world only to return home old, sad, and defeated. As he re-entered his abandoned house, he needed a drink of water. But the well on his property had silted up. Wearily, he took out his spade and dug a new one—and instantly struck the Golconda, the world's greatest diamond mine.

Conwell's message is a useful one. Leaders of the Third World and former communist nations need not wander the world's foreign ministries and international financial institutions seeking their fortune. In the midst of their own poorest neighborhoods and shantytowns, there are—if not acres of diamonds—trillions of dollars, all ready to be put to use if only the mystery of how assets are transformed into live capital can be unraveled.