

PEOPLE IN ECONOMICS

HERNANDO DE SOTO has star appeal. He is on the must-call list of many world leaders. He is feted by the press and funded by international development agencies. His think tank in Peru has produced some of the most influential work in development economics, while his best-seller *The Mystery of Capital* was hailed by *The Economist* as “the most intelligent book yet written about the current challenge of establishing capitalism in the developing world.”

In it, de Soto argues that, despite capitalism’s triumph over communism, the market system is in deep trouble as long as so much of the world remains poor. The key to both spurring development and securing capitalism is enabling tens of millions of poor entrepreneurs across the third world to become part of the system rather than excluded from it by bureaucracy and red tape.

new urgency since the terrorist attacks on New York and Washington in September 2001. In the early 1990s, his proposed reforms were credited with turning people in Peru against the Shining Path Maoist guerrillas, and the 62-year old de Soto argues that his ideas can also be a potent weapon against terrorism internationally by helping remove a major source of discontent.

Part of de Soto’s skill is in telling stories that everyone can relate to. One of his most famous is his barking dog story. The way de Soto tells it, he was vacationing on the Indonesian tourist island of Bali when he was asked to give a presentation about his ideas on property rights to the Indonesian cabinet in Jakarta. They told him property rights were fine, but how, they asked, do you sort out in practice who owns what? “I told them that when I had been walking

Hearing the Dogs Bark

*Jeremy Clift interviews development guru
Hernando de Soto*

Unusually for an economist, de Soto was a successful businessman before he founded his think tank, the Institute for Liberty and Democracy (ILD), in Lima in the early 1980s (see box, page 10). He accumulates more frequent-flyer miles than many corporate bosses, bringing all the skills and tools of a marketing expert to sell his idea that the main problem of development is not that the poor in the third world lack capital, but that many lack the legal title to assets they already hold. Giving them legal title will unleash this “dead capital” so that it can be used as collateral for loans to fund new businesses or expand homes.

“They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. This explains why people who have adopted 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,” de Soto argues.

De Soto’s populist approach has won many converts among world leaders, from Russian President Vladimir Putin and Thai Prime Minister Thaksin Shinawatra to Mexican President Vicente Fox and Afghan President Hamid Karzai. One reason for his success is the zeal with which he promotes his message. In the eyes of many, that message has gained a

in Bali—one of the most beautiful places on earth—I had no idea where the property boundaries were as I strolled through the rice fields,” de Soto said. “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.” Recognized informal property rights could be developed into a formal system of property contracts by heeding the message of the barking dogs.

The metaphor is so effective that, like a musician with a hit song, de Soto is asked to tell the tale again and again. And with good grace, he complies. “Basically, wherever we go, we find the symbol of the dogs barking,” he says. “What we try to do at the ILD is build up a legal system of property that is based on the realities already on the ground.”

International family

De Soto has an infectious enthusiasm. A bearded bear of a man, he comes from a family of international civil servants. His father, a lawyer, worked in the International Labor Organization in Geneva, and his brother, Alvaro, is an Under-Secretary-General at the United Nations. De Soto



himself briefly served early in his career at the General Agreement on Tariffs and Trade (GATT), the predecessor of the World Trade Organization, and later as President of the Intergovernmental Council for Copper Exporting Countries. He also served for a time as a governor of Peru's central bank.

His father had wanted him to be a lawyer, but de Soto said that after reading Paul Samuelson at university, he became convinced that economics was the field that would give him the tools to explore the areas in which he had most interest—particularly how countries developed. After his father was exiled following a military coup in Lima, de Soto was educated largely in Switzerland. He gained experience in the private sector and became chief executive of one of Europe's largest engineering consulting companies. He dealt a lot with overseas markets, gaining insight into the political nature of international aid and export credits. "I became aware of how export credits could be used to further the

interests of suppliers rather than buyers in developing countries, and the politics of the whole thing."

But all the time that de Soto lived abroad, his father insisted that he remain in touch with Peru. In 1980, he returned. He soon realized that to conduct business there it took extraordinary persistence, ingenuity, and bureaucratic savvy unheard of in Europe and the United States. Wondering why, he hired two recent law graduates to count the number of laws and regulations enacted in Peru since World War II. The results were astonishing: Peruvian governments had passed about 28,000 economic laws and regulations a year, creating an ever-growing legal morass. To illustrate the problem, de Soto decided to set up a garment factory in a Lima shantytown with just two sewing machines and attempt to get it licensed. With the help of five university students who spent several hours a day grappling with Peruvian bureaucracy, he discovered that to obtain a license to operate even such a small business took 289 days and

cost 31 times the average monthly minimum wage. It was not surprising that most people bypassed the process, operating without a license.

According to the ILD, “Peru, in fact, had become two nations—one where the legal system bestowed privileges on a select few, and another where the majority of the Peruvian people lived and worked outside the law, according to their own local arrangements.” How large was this extralegal sector? No one in the government seemed to have a precise idea. Once again, de Soto decided to find out for himself. From 1981 to 1984, he and a small group of associates—the original ILD research team—began walking the streets and shantytowns of Peru during late afternoons and weekends, talking to all sorts of people about their work and counting their businesses and enterprises. De Soto and his team discovered a new set of statistics about life in Peru, and their data were astounding: 90 percent of all small industrial enterprises, 85 percent of urban transport, 60 percent of Peru’s fishing fleet (one of the biggest in the world), and 60 percent of the distribution of groceries were effectively in the extralegal sector. “The more people the ILD researchers talked to in the shantytowns and rural byways of Peru, the more they realized that it was not so much that the poor were breaking the law as that the law was breaking them.”

In 1986, de Soto published his findings in *The Other Path: The Invisible Revolution in the Third World*. The title was a deliberate jab at the Shining Path, then active in Peru. (It later targeted de Soto several times.) He argued that poor countries stayed poor not because of capitalism but because capitalism had not been developed sufficiently. It became a bestseller in Latin America and was translated into 10 languages.

Unlocking hidden wealth

At the same time, de Soto was transforming his theory into action. With the support of Alan García, then Peru’s president, and his successor, Alberto Fujimori, the ILD created a plan for Peru’s poor to get title to land and businesses more efficiently. Lima residents needed to deal with just one government agency instead of as many as 14 to obtain a title, lowering the cost of registering a business to \$174. From 1990 to 1995, 300,000 titles were registered in urban Lima. The value of that land typically doubled by 1998. “All of a sudden the government had more tax money at lower rates,” former U.S. President Bill Clinton, who is a fan of de Soto’s work, told the Council on Foreign Relations in New York last year.

ILD becomes a “franchise”

De Soto became interested in the informal sector when he saw dozens of illegal panners sifting for gold along a river in the Huaypetue region of eastern Peru in 1980. Realizing that the gray economy was a largely unexplored phenomenon, he set about visiting shantytowns on the weekends. He went on to found the Institute for Liberty and Democracy (ILD) in Lima, which specializes in documenting the extralegal sector of the economy.

The Institute now has a staff of around 45, comprising lawyers, economists, engineers, urban planners, and information technology specialists. De Soto says he has requests from 25 governments for the ILD to help map the informal sector in their country. De Soto maintains that the ILD will grow, “but not beyond 75 staff.” Instead, he plans what he calls a franchising operation, where his staff train specialists in other countries to do the ILD’s work.

De Soto says he is closely involved at the start of operations in each country, helping to evaluate and diagnose the extralegal sector and proposing reforms that will bring workers into the legal system.

More information at www.ild.org.pe.

In the early 1990s, de Soto got a call from El Salvador’s president, Alfredo Cristiani. Could he replicate his work in that war-ravaged Central American nation? De Soto and his colleagues at ILD trained Salvadorans to set up a system of titling. Since 1997, he’s been consulted by the governments of Haiti, Egypt, Mexico, and the Philippines. More recently, he’s started projects in Ghana and Honduras. He expects to be working with 25 governments over the next two years.

What attracts them about his message is that the key to prosperity lies in their hands through unlocking hidden wealth that already exists. “We shouldn’t just focus on the macroeconomic side of the formula: stable money, fiscal equilibrium, and privatization. The core of the capitalist system, as I understand it, is that it is

essentially a legal property system,” argues de Soto. Making assets fungible by making them legal could unblock trillions of dollars in “dead capital.”

De Soto says that many government leaders ask his advice about how to develop a strategy for selling reform to the people. “The crucial part that they want to know is: How am I going to be able to sell it? I can get a recipe from the IMF, but how do I sell it?” De Soto says the starting point is gathering information. Getting an accurate picture of the informal sector is essential for developing a strategy for incorporating it into the mainstream. In many countries, the gray economy is much larger than the official sector. “There are many statistics on who’s living on \$1 or \$2 a day; who has HIV and who doesn’t,” he says, “but there are no statistics in many countries on who is outside the law.” Overall, the ILD has estimated that the poor in developing countries own some \$9.3 trillion in assets that are not titled.

Supporters and opponents

De Soto’s work has excited many in academia, and the cover of *The Mystery of Capital* carries endorsements from two Nobel prize-winning economists, Ronald Coase and Milton Friedman. “De Soto is arguably the most interesting intellectual writing on development today,” Columbia University Professor Jagdish Bhagwati told *F&D*. “In a field now rife with ingenious micro studies of ‘small’ issues, de Soto is the man with ‘big’ ideas, returning us to the heyday of the pioneers such as Paul Rosenstein-Rodan. His *Mystery of Capital* will endure as a work of extraordinary importance.”

But some other economists and development academics view his conclusions as questionable and tend to be rather

bemused about why his work is such a hit with policymakers. "Though he has scarcely published an article in an academic journal, de Soto's work has had a major impact on development economics," remarks Christopher Woodruff, Associate Professor of Economics at the University of California, San Diego. "He's absolutely right," concedes de Soto, "I don't have an academic background. I'm interested in the real world. My objective is to change countries."

Shortly after *The Other Path* was published, two economists from the London School of Economics, R.G. Rossini and J.J. Thomas, published an article in *World Development* questioning the statistical basis for the ILLD's estimates for the size of the gray economy. Publication of the *Mystery of Capital* induced stronger reactions. Woodruff, writing in the *Journal of Economic Literature*, argues that de Soto has vastly overestimated the amount of extralegal wealth that the poor are sitting on. "Given the inevitable slippage in translating collateral into loans, the capital unlocked from these assets might be only a small percentage of that suggested by de Soto," Woodruff states. He argues that de Soto's own experience in Peru suggests that land titling by itself is not likely to have much effect. Titling must be followed by a series of politically challenging steps. Improving the efficiency of judicial systems, rewriting bankruptcy codes, restructuring financial market regulations, and similar reforms will involve much more difficult choices by policymakers. "These are swept under the rug in the text of *The Mystery of Capital*. Land titling is made to sound like a free lunch. But without a broad set of complementary reforms, property titling and registration systems are likely to have a more limited effect than de Soto's (very refreshing) enthusiasm would lead one to believe."

"I'm not saying," counters de Soto, "that other reforms aren't necessary. I'm simply saying that a property rights system is a principal reform, without which other reforms are difficult to manage. It's quite clear that property law alone does not resolve the other problems. But to me, what is also quite clear is that without property law, you will never be able to accomplish other reforms in a sustainable manner."

Roy Culpepper, President of Canada's North-South Institute, worries that de Soto underestimates the difficulties of unraveling property titles. "Given the contestability of property rights anywhere, establishing who owns what among the poor in developing countries is an enormous undertaking that de Soto downplays. Moreover, de Soto's titling project is inherently biased against the landless and propertyless tenants," Culpepper argues.

Alan Gilbert, Professor of Geography at University College, London, challenges de Soto even further. He finds that in Bogotá, for example, granting legal titles has created neither a more healthy housing market nor a better supply of credit for the poor. He accuses de Soto of "conjuring up a myth about popular capitalism. He is fanning the illusion that anyone, anywhere, can become a fully fledged capitalist." Gilbert says that the danger is that policymakers may

be persuaded that they need do little more than offer title deeds and let the market take over. "Instead of offering an answer to the mystery of capital, he is in danger of generating a myth about capitalism based on a populist dream."

De Soto brushes such criticism aside. "Our enemies like to say that we are good at PR," he says, "but what they don't like to mention is that we are very actively engaged in helping promote reform on the ground. Obviously, property law is not a silver bullet, but it is the missing link. Other reforms won't work unless you deal with the issue of extralegality."

De Soto says that the strength of the ILLD's work is in enabling governments to understand and quantify their informal sector so that they can develop a strategy for change. "What they don't see yet is that the poor are already in a market economy, albeit an extralegal one, fragmented into little pieces. Unfortunately, until today, I know only one organization in the world that is trying to quantify the informal sector in detail, and that is ours.

"Heads of state don't call us in because they have been educated to believe in markets; they call us in because they want a picture of the extralegal sector," de Soto insists. "And many of them make changes when they find out what people want, because any smart politician first of all wants votes. Even if they don't go for votes because there are not many elections, they will go for legitimacy. Whether on the left or the right—they call us in because they don't know what their people are actually doing and because nobody else dedicates themselves to how the informal sector works. And that's going to be crucial in the years ahead."

What's the next project on de Soto's mind? "I've only written a book when I've had something new to say," he remarks. "Now I think I have spotted something significant relating to how enterprise is organized, how it creates wealth. That's what I'm looking at." If his last two books are anything to go by, the new one could well be another best-seller. ■

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