

The Mystery of Capital

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A review of Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), pp. 276.

At long last, Hernando de Soto has provided us with a sequel to his unparalleled tour-de-force *The Other Path*, which in merciless detail described and with cool judgment analyzed the astounding situation facing the poor in the Third World, who in fact have to fight an uphill battle against their own governments, with the only help they get from the West being trickle-down handouts. For, De Soto revealed, it was not the lack of energy or entrepreneurial capacity nor an invincible popular stupidity that produced the poverty in the Third World but governments, both national and foreign, that refused to recognize in their own citizens the spirit of entrepreneurship, their efforts to better themselves, their savings, their accumulated property, but rather wrote them off as shantytown riff-raff whose only hope was birth control. De Soto tore the lid off of this world and forever changed how we look at the poor in the Third World. And now he has published the further development of that book, purporting to provide a philosophical foundation for the phenomenon of capital, telling us again why it is the poor's last best hope, on the material plane, for the future.

The great merit of this book is De Soto's further elaboration of the way fixed, established, secure property rights pave the way for the development of capital proper, that is, property as the means of obtaining credit in order to generate further investment.¹ Property thus generates a multiplier effect that produces compound economic growth. This function of property was recognized most thoroughly by Marx, De Soto argues, and provided the basis for the Marxist critique of capitalism. But, De Soto says, Marx had it exactly backwards: it is precisely this function, succinctly captured in the term *capitalism*, that has proved the salvation of the lower classes of society. For when they too are able to have their property recognized before the law, they too can enter into the capitalist equation and benefit from material prosperity. This is a lesson that was learned

1 De Soto lists other benefits provided by fixed property rights, such as the way they create responsible, committed citizens, the way they, in the case of real property, provide the basis for the provision of public utilities (utilities providers now have the secure knowledge that the property is in fact in existence, is owned, etc., and thus can be billed). But the element of investment-spurred growth seems to me the most important in his argument.

in the West during the Industrial Revolution, and a lesson that must be learned in the Third World today. For the same kind of revolution is occurring there that occurred in the West a century ago.

But there is more. De Soto claims to teach us a great lesson in this book, above and beyond what he presented in *The Other Path*; and that is that extralegality, the informal sector of unrecognised property and its accompanying do-it-yourself judicial institutions, is a *universal phenomenon* which was only overcome in the West in the 19th century. As he puts it (p. 52):

... The reason capitalism has triumphed in the West and sputtered in the rest of the world is because most of the assets in Western nations have been integrated into one formal representational system.

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

Developing and former communist nations have not done this....

It was this "revolutionary" development in the 19th century that sparked the Industrial Revolution the economic progress that is the hallmark of Western society.

So De Soto argues that it was the customary-law orientation of pre-modern European society that lay at the heart of the problem of extralegality, and that overcoming this customary-law approach, as was accomplished in the 19th century in continental Europe through the codification of the private law, is the key to solving the problem of extralegality in the Third World today, and thus unleashing there a capitalist revolution that will sustain economic growth and bring Third World economies into line with the West.

But is De Soto fair in blaming customary law for extralegality and informality? Watch as his argument develops (page 53):

It may surprise the Western reader that most of the world's nations have yet to integrate extralegal property agreements into one formal legal system. For Westerners, there supposedly is only one law -- the official one. Yet the West's reliance on integrated property systems is a phenomenon of at most the last two hundred years. In most Western countries, integrated property systems appeared only about one hundred years ago; Japan's integration happened little more than fifty years ago. As we shall see in detail later, diverse informal property arrangements were once the norm in every nation. Legal pluralism was the standard in continental Europe until Roman law was rediscovered in the fourteenth century and governments assembled all currents of law into one coordinated system.

De Soto's argument thus hinges on equating the integration of property systems with the establishment of unified law codes. These two are, however, far from being identical. In fact, the one -- an integrated property system -- can exist quite independently of the other -- a unified, centrally administered legal system. The one provides information about property that can be accessed centrally. The other provides protection of property. Information and protection are not the same, although protection -- security -- of property does provide the basis for valid information about property. Without security of property, there can be no accurate information about property, because ownership, the source of information about property, is not established.

But what does this have to do with extralegality? Security of property is not the discovery of the last hundred or two hundred years; yet it is this, or the lack thereof, that has created the situation of extralegality in the Third World. Owners cannot get recognition of their property before the law and before the courts of their own country: this is the problem. The problem is not that owners cannot get their properties properly advertised, or that they cannot adequately publish information about their property to potential buyers. But it is precisely these two categories that De Soto runs together in his argument.

Thus, the "extralegality" De Soto criticizes in the Western past is not the extralegality currently being experienced in the Third World. In fact it is not extralegality at all. It is another form of legality, that of customary law rather than centralized legislation. But De Soto never makes that distinction. He simply argues that because there was no centralized legislation and codified law, then there was extralegality. But that is a far cry from systems of law in which property rights are made into high hurdles that only the well-heeled and well-placed can take advantage of; in which great swathes of the population are excluded from the legal system altogether. That is the kind of exclusionary legal order that typifies the Third World, that makes extralegality a necessity for survival, and it is the product not of custom *but of legislation and codification and law codes*.

To make his point stick, De Soto goes to the history books. But he only refers to one

specific set of examples, from the colonial and 19th-century United States. Here he describes the situation in which settlers could not obtain clear title to their land because those lands had previously been granted to large landowners by decree, by colonial assemblies or by governors etc. De Soto claims that the common law did not "provide guidance for how courts should handle cases involving people who had bought or inherited land of dubious title," and that, "more importantly, the English common law of property was often ill suited to deal with the problems that confronted the colonists."² But the fact that there were no precedents to help deal with the new situation does not mean that the common law provided no solutions to the situation. It is precisely in such situations that the common-law approach proves its worth, for it provides a mechanism for dealing with the situations as they arise on the ground. Through the development of precedent, these new situations work their way into law, rather than having to wait for the legislature to write a law to deal with those specific situations. De Soto actually answers his own question, by quoting Konig: "the courts often turned to local town customs and transformed for them into a new body of law that would stabilize land dealings."³ This is precisely the point.

Certainly there have been cases in European and American history of the kind of extralegality that now characterizes Third World. But De Soto does a much better job of describing and analyzing this extralegality in his previous book, *The Other Path*. There he showed that it was the mercantilist approach, and prior to that, the guild mentality, that led to the rise of informal, extralegal industry and business, that pushed otherwise law-abiding people, especially those on the lower rungs of society, outside of the formal, legal sector. This mentality believes that progress must be coordinated from above, and that legislation is the tool to achieve that goal. For the mercantilist mind, customary law is a hindrance to be overcome.

But in *The Mystery of Capital*, De Soto has abandoned the mercantilist paradigm as the key to understanding what is behind extralegality. Instead he has embraced the idea of codification as the solution. But in doing so he is embracing one of the major tools used by the mercantilists; because codification is the means by which legislation has superseded customary law in modern times. For, as De Soto showed so masterfully in his previous book, it was mercantilist legislation that produced extralegality then, and it is neo-mercantilist legislation that is producing it now. Extralegality is not customary law per se, although it evolves into it: where customary law is not recognized it will make its spontaneous appearance willy-nilly.

This book therefore is extremely puzzling to read, at least to readers familiar with *The Other Path*. What De Soto has apparently decided to do is to bring the common-law tradition in for a measure of the blame for extralegality, and champion the pride and joy

² p. 111.

³ David Thomas Konig, "Community Custom and the Common Law: Social Change and the Development of Land Law in Seventeenth-Century Massachusetts," in *Land Law and Real Property in American History: Major Historical Interpretations*, ed. Kermit Hall (New York: Garland Publishing, 1987), p. 339. Quoted on page 112.

of the civil-law tradition, codification, as the solution to extralegality.⁴ This in spite of the fact that De Soto cites various proponents of the customary law/common law approach, such as Hayek, Leoni and Benson. Hayek and Leoni in particular (I plead ignorance respecting Benson, not having read him) argue forcefully that legislation has only a limited role in the sphere of private law, and that the common-law approach is the appropriate approach for a property-rights regime. De Soto himself argued for an approach along common-law lines in his *The Other Path*. Whence the change in philosophy?

I think the answer can be read between the lines of *The Mystery of Capital*. De Soto sounds like a disillusioned free marketeer, disillusioned by the experience of watching former communist countries become ever more corrupt and ever more hopeless at just the time the West moved in to help these countries build free market economies. He appears to believe that the problem lay in the free market ideology itself, which he seems to suggest are one and the same with the policy prescriptions of the IMF and the World Bank. This in itself is mind-boggling. Proponents of the free market have always argued that macroeconomic solutions are no solutions at all, and that solutions must be found precisely in the micro-area of establishing the rule of law, property rights, rights of contract, and the like. But, having convinced himself that traditional free-market proponents never understood the importance of these things, he turns to a rather outdated solution, the solution of codification. Just as legions of legal philosophers argued against codification from the time the idea was broached to the time it was put into practice, contemporary legal historians such as Manlio Bellomo now recognize the bankruptcy of codification and are arguing for a new start.⁵

Apparently, therefore, De Soto has cast his lot with the civil-law approach. He wants legislation to solve the problems legislation has produced. He wants politicians to solve the problems politicians have produced. What he needs to understand is that it is precisely legislation and politics that themselves are the problem. Legislation and politics have only a limited role to play in the development of private law. Legislation and politics are pre-eminently public law institutions. As I have written elsewhere:

Private law, being expressive of commutative justice, has its own inner logic, its own structure which must be respected in lawmaking of any shape. Currently, legislation is the primary source of law, both public and private. The problem with this is that legislation is primarily directed by considerations of distributive and not commutative justice. This is because the legislature is oriented towards public law, it historically has been shaped by public law, and it sees its mission in terms of public law. Add to this the modern social-democratic bias in favor of public law as in all encompassing

4 4. On the common-law/civil-law opposition as the paradigm for understanding the development of Western civilization, see my *A Common Law: The Law of Nations and Western Civilization* (Aalten, the Netherlands: Pietas Press, 1999).

5 5. See Manlio Bellomo, *The Common Legal Past of Europe 1000-1800*, transl. Lydia G. Cochrane (Washington DC: the Catholic University of America Press, 1995).

"social" law, and one begins to see the danger of legislation to the regime of private law.⁶

The primary role of legislation in the area of private law has been to introduce "social" law, geared towards undermining the otherwise entirely just, albeit politically incorrect or undesirable, outcomes which of necessity follow when free persons are left to arrange their own affairs on their own account. This social legislation nicely fits into the neo-mercantilist category De Soto used in *The Other Path*. It is this kind of regulation which distorts the private-law regime and creates the anomalies which in turn spawn informal activity, e.g. the black market.

There is another book I wish De Soto had written; it has to do with another parallel between the 19th century and the Third World of today: the phenomenon of shanty towns, of burgeoning city growth, uncontrolled, off the "radar screen" of officialdom, the object of pity and outrage, exhibit A in the trial of "unbridled capitalism," the enemy of the common man, who was only saved by the rise of the glorious welfare state. I wish De Soto had taken the lead provided by Hayek, first in his *Capitalism and the Historians* and later in his *The Fatal Attraction*, that the phenomenon of shanty towns, far from being a sign of grinding poverty, as in fact a harbinger of economic growth and prosperity for the masses that, tied to the land and grinding existence of subsistence farming, never had been able to participate in the progress of the city. The shanty towns, De Soto now tells us, in fact conceal wealth of enormous magnitude, that only has to be tapped, and the means to tapping this is none other than the rule of law, the availability of cheap yet reliable justice, the availability of notaries and courts through which the assets of the poor become visible to the larger market, the buyer and the seller, the investor. To achieve this, governments need to forget about their plans to provide for their people and rather enable their people to provide for themselves by providing the only thing governments are good at providing, civil justice. And it is precisely this seemingly simple, ever-so-straightforward task that so completely evades both Third World governments and their benefactors in the West, so eager to champion the plight of the poor but so unwilling to do anything fundamental about it.

6 6. Ruben Alvarado, *An Outline of the Common Law: I. The Private-Law Nature of the Common Law* (Christian Cultural Studies Page, WordBridge Publishing: <http://www.wordbridge.net/ccsp>, 2000).