

The Missing Ingredient What poor countries will need to make their markets work

by Hernando de Soto

Those countries which have market economies have prospered so much more than those which have not that today nobody dares propose a solution to underdevelopment that disregards the market. Every year international agencies and successful capitalist nations spend billions of dollars trying to export market-economic systems to the rest of the world. Yet with a few notable exceptions in East Asia, these efforts have failed. Today only some 25 of the 185 nations of the world have made the jump to a developed market economy.

I predict that in the next 150 years the countries in Latin America and elsewhere joining these 25 will be those that spend their energies ensuring that property rights are widespread and protected by law, rather than those that continue to focus on macroeconomic policy.

Why? Because there is not enough property in developing countries to make markets work. The difference between developed and underdeveloped countries, after all, is not that the former have markets and the latter do not. Markets are an old and universal tradition: Christ threw merchants

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out of the temple 2,000 years ago, and we Peruvians were taking our products to market long before Columbus reached America. The difference between developed and underdeveloped countries is the difference between buying gold futures on the London Metal Exchange and buying gold nuggets on a pavement in Madre de Dios, Peru. In Britain the legal system has created property rights that can be exchanged in an expanded market, whereas in Peru it has not. Britain is a property economy, Peru is not.

To be exchanged in expanded markets, property rights must be "formalised" - in other words, embodied in universally obtainable, standardised instruments of exchange that are registered in a central system governed by legal rules. This affords holders indisputable proof of ownership, and protection from uncertainty and fraud. Property rights can then enter the marketplace in a form adapted to massive and frequent exchange - such as cheques, share certificates, promissory notes, bonds, contracts, warehouse receipts or chattel paper which facilitates the transfer of resources to their highest valued use. Modern market economies generate growth because widespread, formal property rights permit massive, low-cost change, thus fostering specialisation and greater productivity. Without formal property, a modern market economy cannot exist.

When it comes to land, property rights are embodied in formalised titles. A piece of

land without such a title to specify its ownership at low cost is extremely hard to market. Any trade of this land will require enormous effort to determine the following: Does the seller own the land and have the right to transfer it? What are its boundaries? Will the new owner be accepted as such by those who enforce property rights? What are the effective means to exclude other claimants? If finding the answers is difficult, then there will be no exchange at all, or exchange will be restricted to closed circles of trading partners who trust one another.

Property rights for land represent a large portion of people's wealth. In the United States they account for over 40% of family assets, and in developing countries like my own some 70% of family assets consist of land. Yet more than 90% of rural and half of urban property rights in Peru are not protected by formalised titles - that is, they are "informal". The situation does not seem to be all that different in the rest of the world, whether it be Algeria, Brazil or Indonesia the absence of formal titles means that the assets of most people in these countries remain outside the market economy.

When people have formalised titles they feel that property is under their own legal control and they therefore have the incentive to invest their intelligence and work in improving it. In Peru, investment in property tends to increase ninefold when squatters obtain formalised title to their homes, and in Costa Rica farmers who are formally titled have much higher incomes than those who

are not. Formalised titles open the door to credit. In the United States, up to 70% of the credit that new businesses receive comes from using formal titles as collateral for mortgages.

Civilised living in market economies is not simply due to greater prosperity but to the order that formalised property rights bring. When poor people have confidence that land is formally theirs, their respect for other people's land increases too. The Viet Cong yesterday in Vietnam and the Shining Path today in Peru made gains among peasants by settling boundary disputes and protecting them from expropriation. Formal title gives the poor of the Amazon basin legal alternatives to selling coca leaves to drug traffickers. As long as the farmers who grow coca remain informal, the government cannot find them, identify them or reach an enforceable crop-substitution agreement with them. And police can act more selectively, thus reducing human rights abuses, if they know who lives where.

Finally, when formal title is not there to provide security of tenure, planning horizons are shorter and so the incentives to protect land, water and forest are missing. Investments to improve the soil, reduce erosion and control the accumulation of rubbish are less likely to be made; informal ownership introduces a bias against the intensive development of existing land and in favour of expansion on to virgin land. When ownership is uncertain, there is a tendency to "mine" the land by maximising its short-run production at the expense of preserving its long-term value. Crops, such as trees, whose cultivation can enhance the environment but which require many years before they turn a profit, are simply not planted.

A WELL-KEPT SECRET

Because the history of Europe, North America and Japan has not been written with an eye to the transition to formal property, few have made the connection between property rights and the development

of a market. One reason why the connection is difficult to see is that the transformation took place over a long period of time as the customs and norms of the peasants were slowly absorbed into formal law. In Germany, for example, the process by which property was formalised began in the 12th century, when written documents first replaced the informal oral rites used by the peasantry, yet it was not completed until 1896 when the *Grundbuch* system for recording land transactions was extended to the whole country.

A second reason why the connection between formalisation and the market has largely been overlooked is that responses to pressures by informal tenants to convert patrimonial land and political concessions into widespread formal property have been remembered as a response to apparently unrelated events.

Thus, the appearance of widespread property ownership in France is recalled as the triumph over feudalism rather than the beginning of a formalisation process. The concessions on property extended to German peasants at the beginning of the 19th century are remembered as a tactic for enlisting their support against Napoleon and insulating them from the effects of the French Revolution, rather than as the official initiation of awarding title to common folk. The granting of formal property rights to homesteaders and squatters in North America is recounted as a political strategy for expanding territory by pushing back Indians, Mexicans and European colonists. In Japan, South Korea and Taiwan after the second world war the massive campaign to formalise the property of farmers is fixed in the memory as a policy to contain communism and weaken local elites, rather than as one of the most important measures taken for market economy systems to flourish.

What this implies is that the genesis of formalised property appears to be from the bottom up, to a great extent the surfacing of an informal law that ran counter to official

law. The transition to formalised property was essentially unpremeditated, something the developed world stumbled into not long ago. The laws that formalised modern property rights only came later, somewhat unconsciously and gradually, and were built on existing informal systems of legal relationships.

For decades informality was considered to be about marginality in developing countries, like black markets, poverty, or unemployment in the developed countries. It was something for anthropologists like Margare Mead, and for Mother Teresa, to worry about. But the explosion of informal activity the sprawling illegal cities - *favelas* in Brazil, *ranchos* in Venezuela, *barrios marginales* in Mexico, *pueblos jóvenes* in Peru, *bidonvilles* in former French colonies, shanty towns in former British ones - and massive rural squatting in the third world over the past 50 years are nothing more than the spontaneous, unbridled emergence of informal property: a process which will require formalisation if this energy is to be channeled into organised and prosperous market economies.

Widespread informal land holdings in developing countries show that leaders have yet to grasp the full significance of informality. If they had, they would have realised that the difference between the developed and the developing countries is in no small measure the difference between countries where property has been formalised and those where it has not. Third world leaders are basically facing the same challenge the politicians of western nations dealt with 100-200 years ago - massive informality appears when governments cannot make the law coincide with the way people live and work. The difference is that today thanks to dramatically larger populations and the communications revolution, there has been a much speedier consolidation of informal property law.

The problem is not that governments of developing countries are unwilling to recognise property rights. Nearly all their constitutions make the right to property funda

mental, and they are parties to treaties, such as the Universal Declaration on Human Rights, which say that equal access to property rights is part of the fundamental rights of human-kind.

Nor is the problem that they do not appreciate the benefits of widespread ownership of property by their citizens. In Latin America, for example, large tracts of land were expropriated and given to poor farmers as part of collectivist agrarian reform programmes, but without reference to informal law. In most cases these reforms did not create satisfactory market economies, not only because farmers proceeded to break up the collective units into defacto small informal land holdings, but also because the individual rights to land were not recognised or formalised.

So far efforts to formalise land and thus to bring it into the market economy have largely failed. One reason for this is that the \$9 billion spent each year on surveying and mapping are geared to the needs of nations that have already formalised land tenure. Although mapping reveals many important things about the surface of the land, it says nothing about who owns what and what is required to formalise property speedily, massively and cheaply.

THE PROPERTY-OWNING BUREAUCRACY

What stands in the way of the formalisation of land is not engineering or surveying or economics. It is law that defines the relationship of ownership rights to people. Property is a collection of rights defined by law which makes no sense outside it. People do not own a parcel of land, or a real-estate unit, but rather what they have are certain rights over the property - to buy, to sell, to mortgage - which are recognised by law. Indeed the governance of a market system is essentially legal: corporations, limited liability, contracts and an adequate business environment are impossible outside the law.

The problem that has to be faced in developing countries is that most rights over property and ownership arrangements are defined by informal law, and formal law has no efficient way to connect with them. As a result, if governments follow official law they have no means for identifying or locating informal settlements nor determining the boundaries of informal parcels. Laws that could help formalisation are burdensome because they incorporate requirements unrelated to the certification of ownership.

Moreover, no single institution is responsible for formalising property: responsibility is spread across a myriad of government departments. And the few procedures for formalising individual parcels are expensive and time-consuming; adverse possession proceedings can take seven years of continuous paperwork. Furthermore, traditional property-registration systems are designed to manage gradual changes in land ownership and are not geared to the task of registering a massive number of informal properties. They are centralised and cannot reach remote places nor process information with the ease and speed required for a market economy.

To make things worse, in Latin America the system demands obsessive concern with paper and the details of authenticity and verification. Well within colonial traditions - even after 170 years of independence from Spain - Latin jurists have been taught to create law through the exegetic adaptation of foreign legal texts. What is missing are techniques that involve citizens: participation, accountability, transparency or common law practices. As a consequence what these lawyers are really good at is adapting law to documents, not adapting law to people. They know much about how property rights are exchanged, but little or nothing on how they are generated.

Change will therefore probably have to come from outside the established legal profession or via legal mavericks. Traditional

jurists tend to be concerned with legal stability - which is just the opposite of change. But since they must take part in the effort, they have to be approached with a deliberate political strategy. Otherwise, as I have learned in my own efforts to formalise property rights, they may well turn out to be its most vigorous opponents.

What has to be remembered is that widespread change to a system of property holding has always been a revolutionary change. This is why, if formalised property is to be accessible to most third world citizens who have land, it has to be the result of a deliberate political decision. It is only at the highest political levels that one finds an encompassing view of all there is to gain from a property revolution as well as the will to overcome the obstacles that will stand in its way.

Until property formalisation is put at the top of the developing world's agenda, the long-run prospects for economic reform will remain poor. The current support for macroeconomic stabilisation programmes in Latin America, for example, is a reaction against the hyperinflation and chaos of the past decade and not a reflection of a fundamental shift in attitude about the virtues of a market economic system. That shift will not occur until the impoverished majority enjoy access to formal property, for only then will they reap the benefits of a market economy. And until the lot of that majority begins to improve, populists peddling inflationary cures for economic ills will inevitably reappear.

When I was growing up in Peru, I was told that the farms I visited belonged to farming communities and not to the individual farmers. Yet as I walked from field to field, a different dog would bark. The dogs were ignorant of the prevailing law; all they knew was which land their masters controlled. In the next 150 years those nations whose laws recognise what the dogs already know will be the ones who enjoy the benefits of a modern market economy. ■

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