The Whoops! Theory of Poverty

*Review of Hernando de Soto's **The Mystery of Capital – Why Capitalism Triumphs in the West and Fails Everywhere Else**.*

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Hernando de Soto's book has been universally acclaimed, with endorsements from people like erstwhile UK Prime Minister Margaret Thatcher, Nobel Laureate in economics Ronald Coarse, former UN Secretary General Javier Perez de Cuellar and fashionable social commentator Francis Fukuyama. This ought to arouse suspicion. Is his thesis so bland, so absent of detail or historical and social context, that it conceals a fatal flaw?

De Soto believes that he has uncovered the biggest mystery in modern economics. His investigation is into the causes of persistent poverty in developing countries. The paradoxes evaporate, he contends, once we understand the secret of prosperity. This secret, he says, is embedded in *capital*. If the working poor were free to tap into the power of capital, there would be an explosive growth in welfare.

The claim is that the poor of Latin America, Africa, Asia and Eastern Europe routinely create value – most notably, in real estate – over which they have no formal legal claims. This prevents them from securitising those assets, and collateralising them by exchanging the deeds for mortgages. *Ergo,* that value is *"dead"*: tied up in land, buildings and equipment that cannot be exploited, cannot be levered through leverage into the formal economy by workers who are relegated to the *"black"* economy, forced to eke an existence outside the legal economic mainstream.

Is this diagnosis correct? Why, then, have the international financial institutions, the ones charged with doing something about poverty, been so blind? In fact, the International Monetary Fund (IMF) and World Bank have been promoting the reforms prescribed by de Soto for several decades, most recently in vigorous style through a mix of policies known as *"the Washington consensus"*.

For the past 10 years, the IMF and Western governments have been pouring billions of dollars into the former Soviet countries, to push them to legitimise the privatisation of their tangible assets so that free enterprise markets can function. From close quarters, I have observed the application of this pressure within Russia. The ideology has prescribed the need to institutionalise the market system – capitalism – by facilitating the ease with which foreign investors can move in to harness the local assets. This requires a western-style structure of property rights and institutions.

Russians, on the whole, have regarded that advice as driven by the desire to lure the income from those assets into the western financial system. Their suspicions may be tested against the economic impact of those property rights in the West, where governments continue to be defeated by mass poverty.

We would find that there was something seriously wrong with conventional economic logic. Some clues emerge before we get past the dust-jacket of de Soto's book. Has Capitalism succeeded in the West but failed everywhere else? De Soto does not offer a definition of capitalism that enables us to scrutinise in detail the processes at work in the West, which include institutionalised poverty.

If capitalism is a system in which people may freely exchange value-for-value goods and services, within a framework defined by the concept of the market, it appears that we have to draw two conclusions that upset de Soto's neat analysis.

- Capitalism in the West, for all its achievements, is notable for its repeated failures. Modern government is principally devoted to economic crisis management.

- Impoverished people in the Third World manage to survive by exchanging the goods and services they provide for prices that are negotiated through a bargaining mechanism that is the market – the capitalist market – in action.

Defined in these terms, capitalism's triumph in the West is a qualified – and unsustainable – one. And it is working in the developing world. The general conclusion is that, as presently constituted, it is a very imperfect system.

WHY DOES capitalism repeatedly trip up in the West? Could it be that the problem originates with the property rights that de Soto unquestioningly endorses for the benefit of the poor?

One hypothesis that would have been worthy of de Soto's scrutiny is the differential characteristics of property rights in land, as opposed to the structures and artefacts that are manually created by the working poor. Might the contrasting qualities lead to the conclusion that, in the West, two distinct economic systems are at work? Could it be that the sector that disposes of land – which is distinguished by intrinsic values that include monopoly power, and the transfer of value from those who create it to the rentiers who add nothing to the value of the nation's wealth – underpins the cyclical failures in the market mechanism?

In developing countries, could it be that existing property rights in land are the great inhibitors of freedom? Was it the power of land, or of man-made capital, that drove the peasants out of their traditional rural communities and into the urban slums? Is it that power which continues to compress two-thirds of humanity in a state of poverty?

Is it possible that, existing side be side in uneasy association, two economic systems operate according to their distinctive logic, periodically colliding and causing the shutdown of activity? If such distinctions do exist, this would suggest the need for policies other than those emphasised by de Soto, if governments are to facilitate the freedom of billions of people.

THIS BRINGS us to a further shortcoming in the de Soto thesis. He does not offer a theory of social exclusion. This is curious, for the author is dedicated to the task of ameliorating the large-scale deprivation that is the norm, rather than the “marginal” exception, in almost all of the countries in the world today. He undertakes this work from his home base in Lima, where he apparently influences the Peruvian government.

It would have been helpful if he had elaborated a theory of social exclusion. We would then be able to test the viability of his prescribed solution:

the need to establish a practical system of legal rights in land and capital.

He cannot claim that poverty originates with the absence of a sophisticated system of property rights, because poverty in the West exists on a massive scale, where it continues to defeat the ingenuity of democratic governments despite the existence of a sophisticated system of property rights. UNICEF, for example reports that in Britain nearly 20 percent of young people live in families that exist below the official poverty line; with Turkey, Poland and Hungary experiencing less relative poverty than the UK.

De Soto’s property rights may be necessary for a modern economic system; but they are not sufficient, if the name of the game is the emancipation and animation of ever citizen. Thus, we need to scrutinise that structure of property rights to determine whether, for example, the opportunity to mortgage the property in the *favelas* and *barios* would cause even deeper (or an alternative kind of) anguish, as with the family indebtedness that is associated with mortgages in the West; whither these property rights would foster a new round of sub-marginalisation – of social exclusion – as the associated tax system kicks in to appropriate part of the incomes earned by the newcomers to the legitimate economy; and whether this, in turn, leads to a further round of deprivation – of social implosion – as institutionalised poverty causes governments to twist the tax knot even tighter.

If de Soto does have a theory of poverty, it would read like this: We forgot to put in place an efficient legal system for real estate, so – whoops! – people are prevented from achieving their full potential because they cannot exploit the wealth that they create beneath their feet.

Does de Soto really believe that the dollar-a-day poverty is the result of inconvenient oversight on the part of governments? It would appear so, given his uncritical acceptance of the formal rights that are expounded in the UN’s Universal Declaration of Human Rights. He notes, with satisfaction, that the constitutions of most countries provide *“equal access to property rights as one the fundamental rights of humankind”*. It may be a fundamental right; but it is *not* matched by corresponding social and legal mechanisms that enforce those rights. The dispossessed condition of billions of people bears witness to this reality.

That may be why the West’s version of *“capitalism”* is not a self-equilibrating, self-sustaining system. Why should it be otherwise in the Third World? Might there be an alternative model that was capable of delivering freedom and prosperity for everyone? Importantly, despite the shortcomings in de Soto’s model of economic development, his book does offer us the opportunity to test competing theories of social exclusion. In particular, some of the less fashionable economic theories may be assessed with the aid of the data that he has compiled.

WORKERS in the extra-legal sectors of the developing world are defined by the fact that they survive without paying taxes to their governments. This offers us an important analytical starting point.

These people in the *"black"* economy do not pay taxes, but they do earn enough to pay for their food and clothes; they also generate enough to acquire the rudimentary tools of their trades, which they deploy with ingenuity to produce the resources that enable them to reproduce their families. But they also do something else. They transfer part of their earnings to landlords, those who claim ownership of the shacks on the hillsides and the great squatter slums that circle the sprawling cities like Rio and Manila. Here is a potentially important fact that is glossed over by the IMF's economic consultants and UN development advisers. It is to de Soto's credit that he has brought this reality to our attention.

The slum dwellers, having for the most part been driven out of their traditional rural communities by landowners, manage to cling to an existence in the *barios* and shantytowns by exercising the ingenuity of humans to survive under the greatest adversity. They also underwrite the costs of providing homes and places in which to work on both public and private land.

Our knowledge of the real estate occupied by these people is dramatically enhanced by the research conducted by de Soto's Lima-based Institute of Liberty and Democracy, which was once assessed by *The Economist* as the second most important think-tank in the world[1]. The value of the real estate which the social outcasts create by their presence is calculated by de Soto and his colleagues at $9.3 trillion US dollars.

" 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."[2]

It is this value, says de Soto, which is waiting to be tapped to engineer an explosive growth in the developing world. The value locked up in the extra-legal sector could be channelled to empower the poor. "This should not, on reflection, be surprising: real estate accounts for some 50 percent of national wealth of advanced nations; in developing countries the figure is closer to three-quarters".[3]

This line of reasoning inspires some interesting themes for further research.
First, rental income is surplus to the productive and reproductive needs of the payers. It is transferred, in the main, to landlords. The classical economists identified this rent – that portion of it that is paid for the use of land – as the tax base for the modern economy; Adam Smith presents the unambiguous statement in *The Wealth of Nations* (1776). If these economists had had their way, land-rent would have flowed into the

public coffers rather than private pockets. Might that have altered the destinies of the first industrialised nations?

Secondly, if that taxable revenue had been socialised, might that have removed the rewards that foster speculation in the asset markets? Would this have channelled finance capital into productive uses rather than the destabilising activities that are always associated with the onset of mass unemployment?

Thirdly, if this revenue had been significant as a fiscal base, would governments have avoided the adoption of taxes that damage people's incentive to work and save? Those taxes – which reflect a specific structure of property rights – are, without doubt, the major restriction on the opportunities at the disposal of working people.

De Soto's estimates of the value of real estate in the extra-legal sector encourage us to locate these questions in the context of the 21st century.

In the informal sectors of the Third World, most of the income from real estate is generated through the land rather than the buildings. The land delivers a flow of rent even greater than what people pay for sites in the legal sector, as the data in Table 1 shows. The fact ought to stop us in our tracks.

Table 1: Land Values, Lima in US$, m²

	Extra-legal sector	**Legal sector**
Lima ①		50
Gamarra ②	3,000	
Aviacion	1,000	
Chinu	400	
Miraflorez & San Isidro ③		500 – 1,000

Source: Technical Evaluations Organisation of Peru, cited in de Soto, *op.cit.,* p82
① Average value for the formal sector
② A great deal of Peru's informal manufacturing takes place in this area, which explains why the value per sq. metre reaches this level.
③ These are Lima's most prestigious addresses, where the value of legal, titled property ranges up to US$ 1,000.

How is it possible for people in the impoverished sector to pay higher rents than are paid for the use of land in the formal sector? One logical answer, suggested by the insights of classical economists: the rents paid in the *barios* and *favelas* are the revenue that government would capture in a society that was grounded in the principles of justice and efficiency. And the lower rents paid in the formal sector are explained by the fact that entrepreneurs and employees are so loaded down by payroll, consumption and savings taxes that they cannot afford to pay as much for the use of land.

This analysis of income distribution suggests ***a theory of social exclusion, associated with a theory of power*** that would be instantly recognised as valid by the deprived in the developing world. In essence, land-rents are privatised because governments fail to capture them to fund public services. This implies that political power ultimately resides with the landowners. The logical concomitant of this is that governments struggle to acquire public revenue out of the net-of-rent incomes of people who work for their living. The tension that this reality creates is the interface between legal and extra-legal spheres of social existence; the point where people are constantly at risk of sinking into a sub-marginal condition.

IS DE SOTO entitled to hold out the prospect of a better life for today's poor in the post-socialist era of triumphant capitalism? Conventional economic wisdom of the kind he promotes presumes that the net gains of the new Information Age will be diffused among the majority. This is the *"trickle down"* theory of development. According to classical economics, however, the net gains will be consolidated into higher rents. This is an empirical issue that ought not to be the subject of ideological disagreement. Had de Soto enlarged his analysis to encompass such considerations, he would probably have generated a more sophisticated set of prescriptions for the governments in Lima and Cairo who are listening to him today.

A major correction to his model of development prescribes the need to harness rental income to finance public services. This conclusion reminds us that his thesis overlooks the role of the public sector in the welfare and operations of people in the private sector. History suggests, however, that meaningful fiscal reform will not happen unless the population at large takes control of its destiny and develops a new philosophy of community.

At the heart of such a new strategy would need to be located the idea that the public and private sectors can work in partnership. That would deliver a different kind of socio-economic system to the capitalism that was inherited from the 19th century. The limits of each sector would be defined by the legitimacy of their incomes. The guiding principles would appear to be the following:

- ***Government has no business appropriating people's earned incomes.***
- ***People have no business appropriating the socially-created land and resource rents***.

This hypothesis can be tested in the light of the benefits that are beginning to flow from the revolution in communication technology. The important point that needs to be continually stressed, however, is that the *"impoverished"* people of the developing world routinely create, by their ingenuity and labour, and independently of the World Bank and philanthropists like George Soros, the communal resources out of which to build new communities.

References

[1] *The Economist*, The Good Think-Tank Guide, December 21, 1991.
[2] H. de Soto, *The Mystery of Capital – Why Capitalism Triumphs in the West and Fails Everywhere Else*, p28. Bantam books, London.
[3] *Ibid*, p76.

Further Information

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