

HERNANDO DE SOTO

The Mystery of Capital

Hernando de Soto is known the world over for his revolutionary views on the causes of wealth and poverty in developing nations. *Title News* was granted the rare opportunity to speak with de Soto about the connection between prosperity and property rights, his work with the Institute for Liberty and Democracy (ILD), an organization he founded, and his efforts to increase global political awareness about property rights reform.

by Michelle Sweet



Suppose you've owned your home for many years—a place where you've labored and invested in its upkeep, raised your family, and built a lifetime of memories. Then suppose that, after all these years, you haven't built equity, and you can't use your home as collateral to get a bank loan because you have no proof that you own it. Adding insult to injury, without such proof, someone else could claim that they own your home or, worse, the government could step in and take it away from you. This sounds unfathomable; yet this is the reality for 80 percent of the world's population.

In his landmark book and international bestseller, *The Mystery of Capital—Why Capitalism Triumphs in the West and Fails Everywhere Else*, Peruvian economist Hernando de Soto describes how lack of formal property rights is the real source of poverty in the world's poor countries.

According to de Soto, prosperity has eluded the poorer citizens of developing nations because, despite the fact that their governments have balanced their budgets, cut subsidies, welcomed foreign investment and dropped tariff barriers, their ability to implement capitalism has failed. Why? Because the majority of their citizens lack the formal property rights that would enable them to generate capital.

"It is impossible for assets to be used productively if they do not belong to something or someone," says de Soto. "How can you confirm the existence of these assets and the transactions that transform them and raise their productivity without a formal property system and the titles that formal property systems provide? A formal property system captures and organizes all the relevant

information required to conceptualize the potential value of an asset and so allow us to control it."

This, according to de Soto, is what unlocks the potential to build wealth. Without legal title to their property, the poor citizens of these nations are effectively locked out of a capitalist system. Since the poor represent the majority rather than the minority, the ability of a nation to implement a capitalist system cannot succeed.

In the face of these insurmountable obstacles, the majority of the poor in these nations live and work outside of the official law, becoming "extralegal."

De Soto's Quest

In 1979, de Soto was running a group of small mining companies in Lima, Peru. Frustrated by the overwhelming number of regulations and bureaucratic red tape, he and a group of colleagues set out to study the number of laws and regulatory hurdles the average citizen had to surmount in order to own property and operate a business legally.

He and his team set up a small two-sewing-machine garment factory in a Lima shantytown and proceeded to get it licensed. It took an astonishing 289 days and cost 31 times the average monthly minimum wage.

De Soto was later to find similar circumstances in other countries. In the Philippines, obtaining legal ownership to a piece of property took 168 steps involving 53 public and private agencies, taking up to 25 years. In Egypt, a citizen had to wend his way through at least 77 bureaucratic

procedures at 31 public and private agencies, taking anywhere from five to fourteen years. In Haiti, a citizen was required to first lease land from the government for five years in order to buy it. To obtain such a lease took 65 bureaucratic steps requiring a little more than two years. To buy the land involved another 111 bureaucratic hurdles and twelve more years, bringing the total time to buy land to 19 years.

In the face of these insurmountable obstacles, the majority of the poor in these nations live and work outside of the official law, becoming "extralegal." Far from being disorganized and scattered, these extralegal societies use their own informally binding arrangements to determine property ownership. These arrangements are upheld by a community as a whole and enforced by authorities the community has selected. These societies represent a vibrant but undercapital-



stand owners, factory workers, and local entrepreneurs.

The data was astonishing. Roughly 90 percent of all small industrial enterprises, 85 percent of urban transport, 60 percent of Peru's fishing fleet, and 60 percent of the grocery distribution businesses operated within the extralegal sector.

"Those who had tried to get into the system by applying for titles to their houses and licenses to operate their businesses found it impossible to overcome the bureaucratic obstacles and years spent in the process," says de Soto.

Another discovery was that, contrary to popular assumptions, the poor did not lack entrepreneurial spirit. These communities were abuzz with hard work and ingenuity. De Soto also found that the poor already have the assets to make a success of capitalism, for even in the poorest countries, the poor save. The value of their savings was, in fact, forty times greater than all the foreign aid received throughout the world since 1945.

"The people have businesses and property, but because they do not hold legal title, they are locked out of the formal, legal economy."

De Soto set out to convince the Peruvian government that the poor were not Peru's biggest economic problem but a major part of the solution. During the next decade, the ILD proposed, developed, implemented, and ran a significant number of initiatives that eventually transformed the economic map and society in Peru.

By 1988, the Peruvian parliament had enacted the ILD's draft "Property Registration Law," which reduced the administrative time to record the property of the poor from more than a dozen years to one month and cut



the costs by 99 percent. To assure that extralegal property was titled and recorded, the ILD helped to create a new organization—Registro Predial—and proceeded to run it on behalf of the government from 1990 to 1996, at which time the government assumed direct control of the property formalization program, hiring existing and former ILD personnel to manage it.

The Mystery of Capital

De Soto estimates that 85 percent of urban parcels and 40 to 53 percent of rural parcels in developing nations are held in such a way that they cannot be used to create capital. He conservatively estimates these untitled assets to be worth 9.3 trillion dollars of "dead capital."

"An astonishing five-sixths of humanity lacks the process to represent their property to create capital," says de Soto. "They have houses, but not title; farmland, but not deeds; businesses that are not licensed or incorporated. These factors explain why people have not been able to produce sufficient capital to make capitalism work."

De Soto looked to the West for answers. In the U.S. every piece of land, every building, is represented in a formal property registration system. By representing their assets with titles, people are able to draw out capital from them.

"Westerners take this mechanism so completely for granted that they have lost all awareness of its existence," says de Soto. "Its origins are obscure and its significance buried in the economic subconscious of Western capitalist nations."

The Roots of Property Ownership in the U.S.

Two hundred years ago, the United States was a Third World country. Squatters dominated the land. Information about property laws was localized and unconnected. Laws had become so cumbersome that they created a major stumbling block for settlers wanting to establish their

The U.S. Title Industry Emerges

As the U.S. property system emerged under one rule of law, real estate titles were handled by “conveyancers” who researched titles or obtained some form of abstract to determine ownership of the land and encumbrances on the title. Based on the title search or abstract, the title could be exam-

■ A capitalist system works in cycles. When a cycle ends is when we realize we have gotten off course and need to recalibrate.

legal property rights, thus extralegal societies began springing up, creating a dual legal system for the young United States.

A legal breakthrough occurred when Congress passed a general “preemption” act in 1841 that allowed squatters who had improved their land to purchase it from the government.

“Although America’s political leaders probably did not intend or realize it, when they constructed national laws such as preemption, they were creating the representational forms that integrated all the loose and isolated property data into a new formal property system,” says de Soto.

De Soto believes current American politicians have lost contact with those early days when America adopted formal property law and invented the conversion process that allowed for the creation of capital. It was an erratic, unconscious process that took hundreds of years.

ined and an opinion rendered by the conveyancer that the title was clear, and thus marketable.

However, there were limits on the protection that conveyancers could provide. This inadequacy of safeguards led to a historic court decision in 1868 that paved the way for the creation of title insurance.

The first title insurance company was formed in 1876 by a group of Philadelphia conveyancers. Subsequent title insurance companies sprang up in New York City, Chicago, Minneapolis, San Francisco, and Los Angeles.

The title industry’s growth during the 1900s paralleled the growth of the U.S. population, from 76 million people in 1900 to 281 million in 2000. By the year 2000, the homeownership rate reached 66 percent of all occupied housing units. Within that hundred-year span, the average number of people per household dropped from six or more to two.

From its inception in the late 1800s, the title industry has grown into a 15-billion-dollar industry. Products and services have expanded to keep pace with the dynamic and rapidly changing real estate market. It was the creation of title insurance that paved the way for the secondary mortgage market in the late 1930s.

“For developing and former communist countries trying to make the transition to capitalism, the American experience is extremely significant,” de Soto writes in *The Mystery of Capital*. “The recognition and integration of extralegal property rights was a key element in the United States becoming the most important market

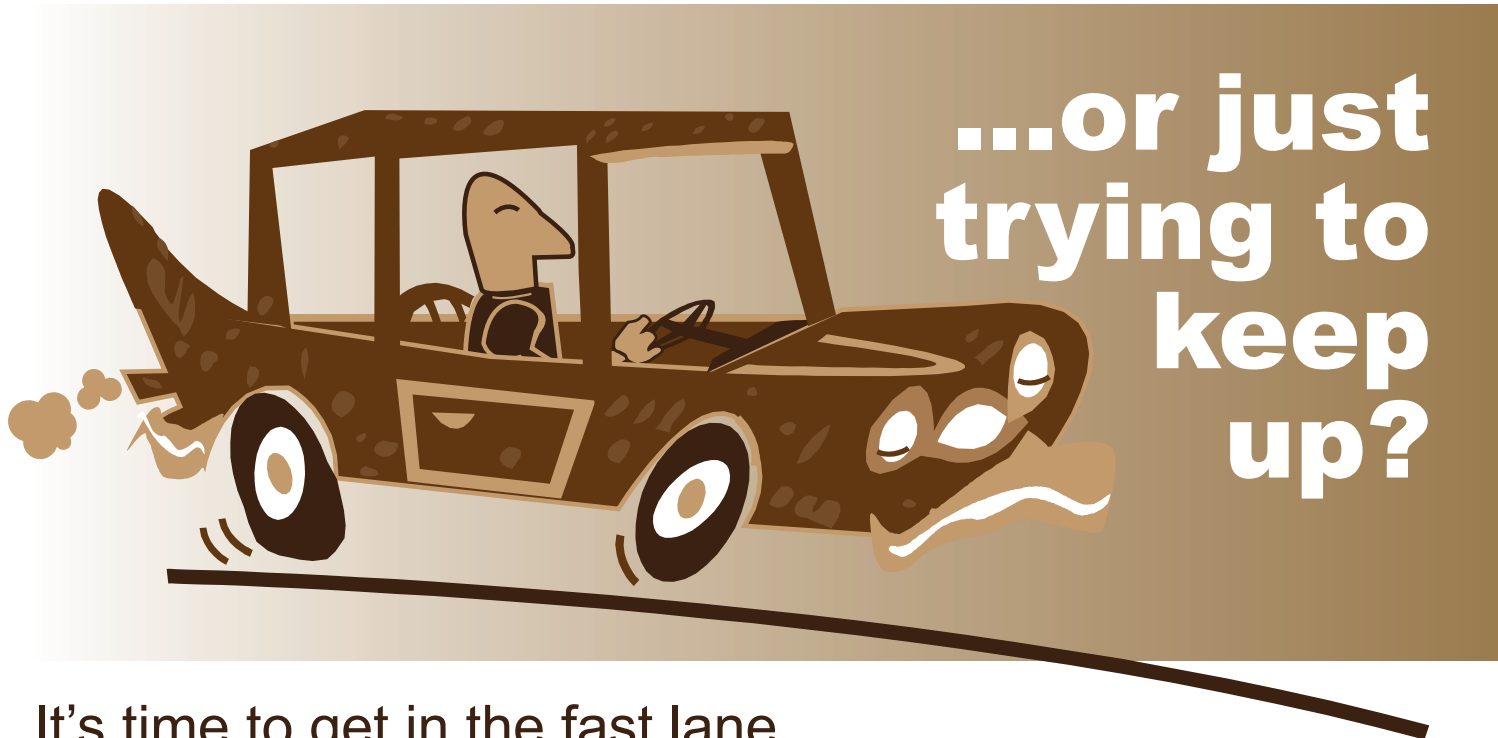
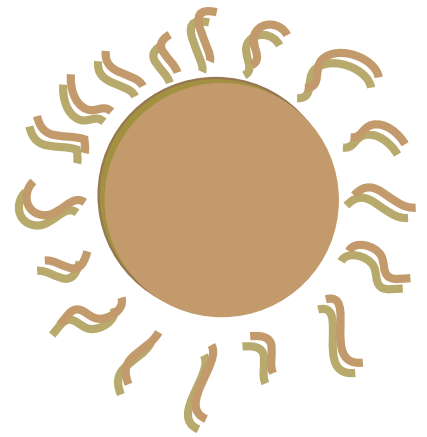
Hernando de Soto



A Peruvian native, Hernando de Soto was educated in Europe and began his business career in Switzerland. His pioneering work has led to global

acclaim. He has received 17 major awards in seven countries for his anti-poverty initiatives. He received an honorary Doctoral degree from the University of Buckingham in 2005. *Time* magazine named him one of five leading Latin American innovators of the century. *Forbes* magazine profiled him as one of 15 innovators who will re-invent the future. The *New York Times* Magazine reported that de Soto’s message is “one of the most hopeful things we have heard in years.”

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De Soto acknowledges that the U.S. has not done everything right. But he feels there is much to be learned from its mistakes.

“Over time, governments lose sight of the real value of things as layer upon layer of instruments makes them lose touch with reality,” said de Soto. “A capitalist system works in cycles. When a cycle ends is when we realize we have gotten off course and need to recalibrate. One of the strengths of capitalist societies is that they learn from their mistakes as opposed to communist and socialist systems where they never admit mistakes.”

Integrating Private Industry in Developing Nations

De Soto estimates that 85 percent of property in Egypt is not legally titled, 90 percent in Tanzania, 50 percent in Peru, and 50 percent in Mexico. In his meetings with heads of state of former communist and developing nations, he has yet to find anyone who does not understand the need to set up a titling system, and who is not interested in doing so. But these countries lack the ability within their existing infrastructures to create a unified property system.

“I have advocated the use of private title insurance because it is so much simpler to pass the problem of security and recordkeeping to the private sector than it is to rely on weak states to implement them—defined and

guaranteed by private institutions that have something to lose.”

De Soto says Russian and other leaders have expressed some reticence about turning over what they perceive as government’s role to private industry. But they are very interested in learning about the U.S. system.

“What they will probably end up doing is creatively plagiarizing what the U.S. has done, adapting it to their circumstances as the issue of property in a developing nation is not just a question of setting up a good record system but seeing how it fits into a particular situation.”

Although de Soto admits the task of setting up a national property system essentially from scratch is daunting, he believes the incentive is there.

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"When a country of 30 million people gets into a property system, we are talking about a contract for ten million titles."

However, a formal property registration and titling system must be supported by a legal framework that does not yet exist in many of these countries.

■ These governments must integrate the extralegal segments of their society, and make the conscious link between property and capital formation.

A Legal Challenge

"Establishing property rights through a formal property registration system is principally a legal challenge," says de Soto. "Without laws, there are no mechanisms for property owners to exercise their rights over their assets."

Every developed nation had to make the transition from an extralegal economy to one under a single rule of law. Common standards in one body of law are necessary to create a modern market economy, says de Soto.

"Had the U.S. not integrated all representations into one standardized property system, it could not have created the means to create the capital that has produced the nation's present wealth."

Political Awareness

According to de Soto, former communist and developing nations are not succeeding at capitalism because they have failed to recognize that their legal institutions have not adapted to

today's economic conditions. Extralegal societies have taken control of vast quantities of real estate.

"These governments must integrate the extralegal segments of their society, and make the conscious link between property and capital formation," says de Soto.

The ILD's efforts have helped

increase global political awareness, especially in light of the failure of capitalism to take root.

ILD Goes Global

De Soto believes the ILD has developed a universal solution to persistent poverty and exclusion in former communist and developing nations. The organization is sought out by presidents and heads of state throughout the world. *The Mystery of Capital* has been translated into 20 different languages.

To date, the IDL has helped countries from Latin America to Africa and Asia, training governments how to determine if they have property rights, how to structure them in such a way that they are uniform, and how to look at the cost of access and transfer.

De Soto worked with President Vicente Fox of Mexico's administration on property rights reform. Egypt is implementing a property rights system developed with de Soto's

assistance. When he met with then Russian President Vladimir Putin, he found that much of ILD's work was being used in Russia. The ILD also is doing work in Afghanistan.

Conclusion

Capitalism is in crisis not because international globalization is failing, but because developing and former communist nations have been unable to globalize capital within their own countries, says de Soto. Only 25 of the world's 200 countries produce capital in sufficient quantity to benefit fully from expanded global markets.

De Soto reiterates, "No nation can truly achieve capitalism unless they overcome the split between those who can create capital and those who cannot. Without formal property rights, no matter how many assets the poor accumulate or how hard they work, they will not be able to prosper in a capitalist society. At the end of the day, a market economy is nothing but the exchange of property rights."

"Many countries could spark more business investment--both within their borders and from the outside--if they did more to guarantee property rights, cut red tape, and so on." Bill Gates ("How to Fix Capitalism," TIME, August 11, 2008).

Hernando de Soto

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Michelle Sweet is Editor-in-Chief of Title News.