The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else

By Hernando De Soto, London: Bantam, 2001, 320 pages, paperback, $63.53. Reviewed by Noel Pearson in the September 2001 issue.

This is a very interesting book setting out a compelling theory on how the great majority of the world's population (the poor in the Third World and in the former communist states) are locked out of the ability to participate in and benefit from the key processes of capitalism: the ability to form capital.

Hernando de Soto is active across the Third World working from the Institute of Liberty and Democracy in Lima, Peru in his words, the quest to create a non-discriminatory market system where the law helps everyone to have an opportunity to prosper. Though the communist states have collapsed and capitalism is the only game in town, de Soto argues that the great majority of the world's peoples living outside of the West suffer a basic discrimination -- where access to participation in the capitalist process is denied to them. There is a system of capitalist apartheid between the West and the rest.

De Soto's central metaphor describing these two different worlds is the bell jar, taken from this question posed by the French historian Fernand Braudel in *The Wheels of Commerce* (New York, Harper and Row, 1982):

The key problem is to find out why that sector of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole economy of the time?

Western countries live within the bell jar and there are enclaves of bell jars within the Third World and the former communist states where capitalism thrives...but they are surrounded by a great mass of society that live in a black economy, where capital formation is impossible. So global capitalism is not an all-pervasive phenomenon -- it is confined to those elites who live in capitalist bell jars in the West who are interconnected with those living in capitalist enclaves in the rest of the world.

The first insight that de Soto has is that the poor that have congregated in shanty towns on the fringes of Third World cities...where billions of people have moved from subsistence rural lives to seek better fortunes in the cities (a gigantic movement away from life on a small scale to life organized on a large one)...are not without enterprise or assets. His organisation undertook a decade of research in a number of Third World cities where they sought to calculate the assets of the poor. They calculated that the homes and businesses of the poor living in the extra-legal sector far exceeded the value of capital in the legal economy of the relevant countries, and far exceeded the value of foreign aid. As a total value the poor owned massive capital, worth in the billions. And there was no shortage of economic activity, manufacturing and trade.

But the problem they found was that the poor, because they live in the extra-legal black economy, are unable to engage in capital formation because they own dead capital. They have assets which have limited legal and economic currency...only protected and recognised by informal social contracts developed within these poor communities. They do not own assets whose economic potential can be represented in ways that would allow people to leverage capital out of their assets.

Why are the poor confined to the extra-legal sector? Not necessarily by choice. Life in the black economy could be just as, if not more, costly, than life in the legal economy. Enterprise in the black economy is terribly inconvenient and there are great barriers to growth and access to capital.

De Soto's researchers sought to understand why the poor remained outside of the bell jars of the legal economy. They undertook research projects trying to register businesses and land titles...and discovered the huge cost, impossible bureaucracy and endless time delays facing the poor in trying to become legal. Even if people wanted to become legal, they couldn't:
The poor inhabitants of these nations -- the overwhelming majority -- do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. It is the unavailability of these essential representations that explains why people who have adapted 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.

This is the mystery of capital. Solving it requires an understanding of why Westerners, by representing assets with titles, are able to see and draw out capital from them...But only the West has the conversion process to transform the invisible to the visible. It is this disparity that explains why Western nations can create capital and the Third World and former communist nations cannot.

The absence of this process, in the poorer regions of the world where five-sixths of humanity live, is not the consequence of some Western monopolistic conspiracy. It is rather that Westerners take this mechanism for granted that they have lost all awareness of its existence. Although it is huge, nobody sees it, including the Americans, Europeans and Japanese who owe all their wealth to their ability to use it. It is an implicit legal infrastructure hidden deep within their property systems -- of which ownership is but the tip of the iceberg. The rest of the iceberg is an intricate man-made process that can transform assets and labour into capital. This process was not created from a blueprint and is not described in a glossy brochure. Its origins are obscure and its significance buried in the economic subconscious of Western capitalist nations.
You will need to read the book to gain a fuller picture of de Soto's theory. Essentially de Soto argues that the lack of an integrated system of property outside of the bell jar means that the poor are confined to a circumstance where their considerable assets and economic activity are locked out of the process of capital formation. He argues that the story of the Third World and the former communist states today is the story of the United States and Western countries 100/200 years ago. He outlines the history of legal reforms that integrated property law in the United States and points to the parallels between the former situation in the US and the current situation of the poor today.

De Soto's theory is that property has 6 effects:

Property Effect No.1: Fixing the Economic Potential of Assets

...a formal property representation such as a title is not a reproduction of the house, like a photograph, but a representation of our concepts about the house. Specifically, it represents the non-visible qualities that have potential for producing value. These are not physical qualities of the house itself but rather economically and socially meaningful qualities we humans have attributed to the house (such as the ability to use it for a variety of purposes that may be secured by liens, mortgages, easements and other covenants).

Legal property thus gave the West the tools to produce surplus value over and above its physical assets. Property representations enabled people to think about assets not only through physical acquaintance but through the description of their latent economic and social qualities. Whether anyone intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital, where assets can be viewed in their full productive potential.

Property Effect No.2: Integrating Dispersed Information into One System

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

Yet the West's reliance on integrated property systems is a phenomenon at most of the last two hundred years.

Property Effect No.3: Making People Accountable

The integration of all property systems under one formal property law shifted the legitimacy of the right of owners from the politicized context of local communities to the impersonal context of law. Releasing owners from restrictive local arrangements and bringing them into a more integrated legal system facilitated their accountability.

Property Effect No.4: Making Assets Fungible

Unlike physical assets, representations are easily combined, divided, mobilized and used to stimulate business deals. By uncoupling the economic features of an asset from its rigid, physical state, a representation makes the asset 'fungible' -- able to be fashioned to suit practically any transaction.

Property Effect No.5: Networking People

Few seem to have noticed that the legal property system of an advanced nation is the centre of a complex web of connections that equips ordinary citizens to form ties with both the government and private sector, and so to obtain additional goods and services. Without the tools of formal property; it is hard to see how assets could be used for everything they accomplish in the West...

...Properly understood and designed, a property system creates a network through which people can assemble their assets into more valuable combinations.

Property Effect No.6: Protecting Transactions

One important reason why the Western formal property system works like a network is that all the property records (titles, deeds, securities and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Their first stop is the public agencies that are the stewards of an advanced nation's representations.

Although they are established to protect both the security of ownership and that of transactions, it is obvious that Western systems emphasise the latter. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital.

The relevance of de Soto's thesis to the position of Aboriginal people

Our situation is not the same as the people about whom de Soto is writing. We do not have large populations engaged in trade and commerce in black economies on the fringes of large cities. We don't have the vast human markets and the experience and engagement in enterprise of these Third World situations. But the analysis about the poor being locked out of the ability to form capital because of our ownership of dead capital and inability to represent the assets we do have in fungible forms -- is completely relevant to our situation.

Aboriginal communities living on Aboriginal lands (though we own 'property') are locked out of the Australian property system that enables capital formation. All of our assets, in the form of lands, housing, infrastructure, buildings, enterprises et cetera -- are inalienable and have no capital value therefore. They cost (huge amounts of) money to develop and to replace and renovate -- but they don't have a capital value. And billions of dollars transferred from government to Aboriginal communities ends up in the form of dead capital: it cannot be leveraged to create more capital. We are therefore in a dead capital (poverty) trap.

If say the Cook Shire Council receives a government grant to construct a public building, that building is a capital asset that is fungible. It can be represented as property to secure mortgages or other means of capital raising. But if the Hope Vale Aboriginal Council constructs a similar building -- the building is 'worthless' beyond its use as a public building. The Cooktown building has value beyond its use as a public building -- it can perform other functions as capital.

This dead capital trap has valid cultural explanations. It is one of the consequences of (i) the communal nature of our traditional title landholding and (ii) the principle of inalienable land title (which may have had its origins in the common law, and has been given statutory force in relation to most forms of land title).

It also has historical explanations: governments and missionaries maintained paternalistic policies which curtailed the ability of Aboriginal people to own or accumulate fungible economic assets.

But there are also other reasons why we are laden with dead capital. The laws that govern our property and asset ownership (State lands legislation, native title legislation, Indigenous Land Corporation legislation, ATSIC legislation) make our assets un-fungible -- beyond the protection of inalienability. Land title-holding structures are unnecessarily complex and inefficient so that they make it too difficult to leverage value out of our assets. Two owners for one area of land (say Land Trusts holding inalienable freehold title to land and Prescribed Body Corporates holding native title to the land) make the land un-amenable to capital formation.

And lawyers and Land Councils (and ATSIC and ILC) create these inefficient and complex structures without any thought to how workable the ownership structures and decision-making and land use procedures might be for the purposes of economic development.

The reduction of valuable assets into valueless capital through inefficient Aboriginal property laws that are unique to Aboriginal people -- is the same story that de Soto is talking about in relation to those structurally precluded from capitalism in the Third World and the former communist states.

And there are many (more ephemeral) property rights and other capital potential embedded in native title law -- which remain out of our reach because of our inability to represent these assets through a lack of legal and entrepreneurial imagination. For example, Indigenous Land Use Agreements (ILUAs) under the Native Title Act 1993-1998 (Cth) -- rather than just being a post-negotiation tool to confirm agreements -- could become representable assets that have capital value, if Aboriginal groups treated ILUAs as *potential* commercial assets. ILUAs have a potential commercial value because they embody valuable commercial features -- time efficiency, certainty about legal compliance, time value of money et cetera -- and they could be used as fungible assets in commercial negotiations. But the process of turning procedural instruments like ILUAs into commercial assets requires legal imagination and entrepreneurial skill -- something that is completely lacking in the legal and professional advisory industries that are normally advising Aboriginal clients.

I think we need to keep the de Soto thesis, and its relevance to the situation of Aboriginal people, firmly in mind. It is relevant in at least the following ways:

- We need to keep it in the front of our minds in our PBC Project. We need to ensure structures are economically efficient. Whilst the land may be inalienable, there are other ways in which the lands can remain as fungible property (leases, licences, ILUAs et cetera) -- but inefficient decision-making structures and dual title-holding bodies can effectively kill off any economic potential of the land.
- We need to keep it in the front of our minds in the context of land transfers and native title determinations (and ILC titleholding structures).
- We need to find possible solutions that might increase the fungibility of Aboriginal-owned assets within the constraints of inalienability.
- We need to find alternatives to capital raising other than alienable property.
- We need to consider the wisdom of continually investing all of our government transfer income (and our own capital) into the dead capital zones which are our communal, inalienable lands. It may be that we need to invest in assets in the real external economy.
- We need to consider how home ownership should work for Cape people. We don't want people breaking their backs to pay for homes to just end up owning dead capital.

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