

The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else, by Hernando DeSoto. Reviewed originally in 2004 by H. William Batt, Ph.D., for Georgist network publications, this is an update for inclusion in an 2009 anthology. (For a somewhat out-of-date bio of Dr. Batt, see www.schalkenbach.org/schalkbios.html)

After its winning nine prestigious awards from mainstream economic and public affairs organizations, why have we Georgists not reviewed this book earlier!¹ No book's thesis more directly flies in the face of our own arguments than what Dr. Hernando DeSoto has proposed. And now, with the rave reviews given to this, his second work, we are compelled to confront what he claims, and to expose the sleight-of-hand in his argument. In the absence of more qualified adherents of the Georgist persuasion, I have set myself this task.

DeSoto is president of the Institute for Liberty and Democracy headquartered in Peru. Writing from the global South,² he is able to say things that, coming from the World Bank, the International Monetary Fund, or any similar organization, would appear crass and self-serving. Early on in the book (p. 37), he says, "[l]eaders of the Third World and former Communist nations need not wander the world's foreign ministries and international financial institutions seeking their fortune. In the midst of their own poorest neighborhoods and shantytowns, there are -- if not acres of diamonds -- trillions of dollars, all ready to be put to use if only the mystery of how assets are transformed into live capital can be unraveled." The conscience of the global North is thus assuaged: it's not the fault or the insensitivity of the wealthy nations that so many people of the world live in poverty; rather it stems from an inability of impoverished countries themselves to leverage the capital assets that they have. The rest of the book attempts to substantiate this argument, or rather to explain why "the one thing that the poor countries of the world cannot seem to produce for themselves [i.e., investment capital], no matter how eagerly their people engage in all the other activities that characterize a capitalist economy." (p.5.)

The key to capital development and economic modernization, he argues, comes from the capacity to leverage what capital assets already exist. And the most commonly and easily leveraged asset is real estate. But because titles in poor nations, to real estate property especially, are not secure and protected in the law, they cannot serve as collateral for further loans. "The result is that most people's resources are commercially and financially invisible. Nobody really knows who owns what and where, who is accountable for the performance of obligations, who is responsible for losses and fraud, or what mechanisms are available to enforce payment for services and goods delivered. Consequently, most potential assets in these countries have not been identified or realized; there is little accessible capital, and the exchange economy is constrained and sluggish." (p.32) He goes on to argue that, conservatively, "about 85 percent of urban parcels in these nations, and between 40 percent and 53 percent of rural parcels, are held in such a way that they cannot be used to create capital. . . . By our calculations, the total value of the real estate held but not legally owned by the poor of the Third World and former Communist nations is at least \$9.3 trillion."

Where is this capital? It lies in every legally-secured asset: "every piece of land, every house, every chattel," all "formally fixed in updated records governed by rules contained in the property system." (p.48) He suggests that in developed economies, "up to 70 percent of the credit new businesses receive comes from using formal titles as collateral for mortgages," (p.84) and that "real estate accounts for some 50 percent of the national wealth of advanced nations." (p.86) Nowhere, however, is this identification of "capital" parsed for what it really is: largely land. As a true neoclassical economist, despite his ritual homage to Adam Smith, everything that the classical economists and we Georgists would call land is conflated into capital. To DeSoto it is the land in almost all instances that provides the leverage for capital equity and accumulation, secured under authorized titles as property.

Of course, for those of us of a Georgist persuasion, land is not capital at all. Rather, as students of economics at least since Smith, through Malthus, Ricardo, Mill, and George maintained, land is a category unto itself, a generic catch-all name which today means all natural resources. These include not just locations on the surface of the earth and sea, but air, water, fossil fuels and minerals, the electromagnetic spectrum, airport time slots, and any other elements of market value not made by human hands or minds. (It hardly changes the import of George's thesis to include resources like the air or the spectrum, which had no scarcity value at all when he was alive.) Nature cannot in any sense be owned, at least not in the sense that I own my car; rather it is used in accordance with, and at the sufferance of, the community. Or, if we call it owned, it is for purposes of use, not to buy or sell as a commodity or as collateral in market transactions.

Where labor compensation is paid in wages and capital tools are paid for by interest, the market price or yield of land comes in the form of ground rent. But neo-classical economics textbooks have scuttled land as a separate factor of production, and it, along with rent, has largely dropped out of their vocabularies. So-called economic rent as a proportion of national products is trivialized and rendered unworthy of further discussion except sometimes in passing or for completeness. Professor Mason Gaffney argues that the elimination of land and rent as a separate category was a deliberate machination of powerful interests at the end of the 19th century, largely banks and railroads, to rearrange economics and tax regimes to suit their institutional advantage.³ The formalization of property law concurrent with the commodification of land further obfuscated the significance of rent as the socially created price dividend from land sites.

Adam Smith deemed "Ground rents and the ordinary rent of land . . . are the species of revenue that can best bear to have a peculiar tax imposed upon them."⁴ He understood that, absent the public recapture of this rent, it was capitalized in prices, which in its less liquid form actually inhibited market performance. In contrast, removing rent from the circular flow allowed markets to perform at optimum levels. The social recapture of rent thus made it the ideal tax. There was also a compelling moral ground for its recapture, because rent was otherwise an "unearned increment" falling to titleholders as a windfall. Better, they argued, that what one created by one's labor was respected as one's own; but that which owed its price to the community rightly belonged

to the community. John Stuart Mill⁵ made this clear by noting that “Landlords grow richer in their sleep without working, risking or economizing. The increase in the value of land, arising as it does from the efforts of an entire community, should belong to the community and not to the individual who might hold title.” Henry George continued this logic by arguing that the capture of monopoly title of natural resources is nothing less than theft, and compared freehold ownership of land to the ownership of slaves. "Thou Shalt Not Steal!" he told the New York City Anti-Poverty Society in 1887.⁶

Studies now show that the proportion of rent in the economy today is far higher than neoclassical economics textbooks typically claim. Accounting methods in most nations make its total difficult to calculate, but it has been convincingly demonstrated to be about a third of total economies. Rather than rely on more onerous tax regimes that carry so many acknowledged downside liabilities, financing public services through rent recapture is fully adequate to support the general services of government. This thesis has come to be known as the Henry George theorem, and has been explored by some of our most noted economists, Joseph Stiglitz for one.⁷ Allowing rent to be otherwise retained in capitalized form and relying instead upon other revenue streams means that the public pays twice: first by taxes on their wages and goods and then again in mortgage payments on inflated land purchased for residential or business purposes. Moreover, taxing land rents conforms to all the textbook principles of sound tax theory: it is efficient, neutral, equitable, administrable, stable, and simple.⁸ The work of economists Terry Dwyer in Australia⁹ and Mason Gaffney in the US,¹⁰ to name two, invites us to look more closely at the various now hidden tax capacities of land.

The metaphor DeSoto employs to distinguish land as a capital asset from other forms of capital is revealing. His analogy is a lake, first available only as potential energy, until such time a dam is built to capitalize its kinetic power. The lake's utility as capital is "locked up" until such time as its title makes it securely available for exploitation. "Just as a lake needs a hydroelectric plant to produce usable energy, assets need a formal property system to produce significant surplus value." (p.48) What is lacking in this analogy is any explanation of the value of the lake, or land. It is as if the value inhered in the resource itself absent its availability and use in the economy. One might ask what value the spectrum had prior to the invention of the radio, or what value Manhattan Island had prior to the arrival of European settlers and its use as a port. Locations have value only with respect to the use that people can put to them; they are a function of market exchanges, of where people choose to congregate, not due to the mere existence of ownership titles. Furthermore, there are many components to a title, what lawyers refer to as a "bundle of rights." All property titles are contingent and no title is absolute. Who owns the rights to the flow of rent is separable from any title and is still an unresolved matter, explained only by the fact that rent as a concept disappeared from common discourse just at the time when land came to be regarded as a commodity.

Nowhere does the author explore the origins or legitimacy of those titles, how they might have been secured or whether they were fairly gained. It is sufficient, only, that those titles are guaranteed for current purposes. "Capital is born by representing in writing - in a title, a security, a contract, and in other such records - the most

economically and socially useful qualities about the asset as opposed to the visually more striking aspects of the asset." (p. 49) This explanation for the value of natural capital should strike most people, especially economists, as quaint. The moral dimensions of such land ownership are totally overlooked. The way to challenge the whole thesis is by asking DeSoto to defend the legitimacy of real estate titles - wherever they are.

The origin of real property ownership in fee simple is a uniquely Western device; even if long in coming, it has become fully manifest only in the past three centuries. To Locke, property consisted of that with which one "mixed his labor," which essentially meant clothing, armaments, tools, and so forth; never land.¹¹ But settlers to North America and elsewhere were quickly absorbed in a gigantic "land grab," imposing a totally alien system of law and economics upon native peoples. "What is this you call property?" Massasoit, a leader of the Wampanoag, asked the Plymouth colonists whom he had befriended in the 1620s. "It cannot be the earth, for the land is our mother, nourishing all her children, beasts, birds, fish, and all men. The woods, the streams, everything on it belong to everybody and are for the use of all. How can one man say it belongs only to him?" A Shawnee spokesman continued, "We do not understand measuring out the lands. It is all ours." (Quotes from Linklater, *Measuring America*¹²) This land grab would play out worldwide and continues today. It took pivotal turns when the US Supreme Court decided *Johnson v M'Intosh* in 1823¹³ and in similar cases in the English colonial empire. In this way, native peoples were deprived of their lands and those lands converted to a commodity system that was an instrument of capitalist exploitation.¹⁴ The privatization of "the commons" continues today in many forms, the term "land grab" just as often still invoked. The rights of private property are increasingly broad, and are now the greatest hallmark of modern western political-economic designs. When President George Bush proclaimed his goal of spreading "freedom" to distant lands, he was mostly talking about the protection and expansion of property rights, especially corporate.

De Soto spends considerable ink in exploring the history of American economic development, for he sees in its history the key to success elsewhere. Chapter Five is an extended treatment of the "evolution of property" in the USA (p.108), observing that the progress of making it "open to all" (p.109) is not yet complete. The granting of titles is treated extensively - the eviction of squatters, the reward to soldiers, the surveying and marking of boundaries, and the employment of "cabin rights" and "corn rights." DeSoto notes at one point (p.117) that squatters "were constantly provoking conflict with Native Americans by invading their lands," but the moral questions he never addresses. The ethnocentric and even arrogant presumptions implicit in all this history, together with the author's unabashed approval of this historic record beg for response.

His debt to the most prominent historians on the subject is replete – Gates,¹⁵ Hoffer,¹⁶ and Aaron Sokolski's *Land Tenure and Land Taxation in America*, published in 1957 by the Georgist Schalkenbach Foundation¹⁷ – and makes clear that he has read the literature. He also has extensive treatment of a controversial 1821 case that grounded the "rules of property" in English common law. One Richard Biddle, a squatter who had settled on land titled to Green, was adjudged liable to pay not merely for the land he occupied but for any improvements that were made. The Court then later reaffirmed that

occupancy laws deprived "the rightful owner of the land, of the rents and profits received by the occupants." But the backlash to this decision was so profound that it inspired statutes in other rapidly settling western states quickly making Green a nullity.¹⁸ The sanctity of title in fee simple continued to evolve over the course of the next century. Titles for mining claims came to have the same standing as those for farmlands.

Legal skirmishes, one must note, would continue in the US throughout the 19th century, and explained the rise of Martin Van Buren to prominence in New York State and later to the presidency. Vestiges of medieval feudalism survived for a time along the Hudson River in huge estates granted to Dutch and English-American "patroons." Squatters on these lands were, under the old economic logic, required to pay rents to the titled owners; their refusal ultimately culminated in what came to be known as the "rent wars." The courts wrestled with these issues of ownership and contract until the 1880s before abandoning this legacy of feudalism. It culminated in a victory for freehold ownership, the history of which is usually related as an unadulterated chronicle of progress. But it can also be viewed as another step in the erosion of common wealth.

DeSoto accepts the argument of historian Richard White¹⁹ by quoting in part: "[T]hrough occupancy, preemption, homesteading, miners' laws, and such, Americans built a new concept of property, 'one that emphasized its dynamic aspects, associating it with economic growth,' and which replaced a concept 'that emphasized its static character associating it with security from too rapid change.' American property changed from being means of preserving an old economic order to being, instead, a powerful tool for creating a new one. The result was expanded markets and capital needed to fuel explosive economic growth. This was the 'momentous' change that still drives U.S. economic growth." (p.149-150) Misfortune befell those who did not learn the new game of property titles.

That secure land titles undergird "the 'momentous' change' that drive U.S. economic growth" is a very tendentious claim, and yet is the core of DeSoto's thesis. Certainly capture of land titles offers advantages to individuals positioned to secure them. But individual gains do not necessarily assure collective social gains: for every winner there may well be a loser, and in this history there were many losers. The equations the argument relies upon seem not to have included all factors; the conclusions seem to rely too much upon narrowly focused and increasingly irrelevant criteria of economic growth. Moreover, "post hoc, propter hoc" does not an explanation make; one needs a contrary-to-fact thesis, something which history can't provide.

In economic theory, however, recognizing rent arguably makes investment capital more available. Denying its reality compels reliance upon taxes of an inferior nature. In both developed and developing nations the leaden weight of taxes on wages and goods demonstrably hinders market activity. The failure to recapture natural resource rents constrains public sector services, and allows, and even encourages, titleholders to keep them out of market circulation for speculative gain.

Economic rent in its various forms has had a role in every civilization and throughout recorded history. Its payment for the use of natural resources has taken many forms: in corvee labor, in tribute, in coin and in commodities. It is a reality in any detached economic analysis. It is the neoclassical economic paradigm alone that fails to recognize its existence, and to the detriment of those societies' market systems. By not recognizing land as a separate factor of production, there is of course no recognition of economic land rent. DeSoto's reliance upon neoclassical thinking gives landowners a free lunch and denies workers the full rewards of their toil. Yet, somehow, capital is transmuted into more capital, simply by virtue of the security of property titles.

Despite our Georgist criticism, DeSoto's thesis is definitely sound in parts: title security needs to be granted to its users if improvements are to be tied to locational sites, else the risk to investment will likely be too high to sustain. No homesteader can venture a large stake in a site if he realizes that it may be taken from him. No miner can risk so much transformation of labor to capital, if the land on which he builds may soon be lost. Land titles are important. DeSoto has a point. But his reliance on freehold property title to land, the birthright of us all, to provide financial collateral is problematic and unjust. It serves the interests of propertied elites by shifting the burden of paying for public services off titleholders of natural resources, and onto the backs of those who labor.

The failure to recognize land rent means that taxation of labor and capital leads to lowered productivity. In taxing those other factors, resources are often kept off the market and the efficiency and productivity of the economy is compromised. DeSoto fails to recognize that the collection of land rent, were it identified, would provide the perfect revenue source. It would not reduce the wealth of societies or the growth of capital one whit; rather it would inspire it. The Georgist point of view is a compelling answer to *The Mystery of Capital*; it needs only to be repeated and demonstrated anew.

Batt New Review of DeSoto,rtf
February, 2009
Word Count: 3,275

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¹ DeSoto, according to Wikipedia, has as of 2009 received over twenty awards as this review is updated.

² Wikipedia notes, however, that he spent almost all his early life in Europe as the son of a Peruvian diplomat, and was indeed educated in Switzerland.

³ Mason Gaffney, *The Corruption of Economics*. London: Shephard-Walwyn, 1995; <http://homepage.ntlworld.com/janusg/coe/index.htm>

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- ⁴ Adam Smith, *An Inquiry into The Wealth of Nations*, Section 18, page 833.
- ⁵ John Stuart Mill, *Principles of Political Economy*. bk.5, ch.2, sec.5.
- ⁶ http://www.wealthandwant.com/HG/George_TSNS.html
- ⁷ Richard Arnott and Joseph Stiglitz, "Aggregate Land Rents, Expenditure on Public Goods, and Optimal City Size," *Quarterly Journal of Economics*, MIT Press, Vol. 93(4). Pp. 471-500; also NBER Reprints, 0102
- ⁸ I have addressed this matter in several places, one in an article published in *State Tax Notes*, Vol.35, No.6, 2 February 2005, pp.377-381, and available online at www.wealthandwant.com/docs/Batt_3legged.html
- ⁹ Terry Dwyer, "Taxable Capacity of Australia's Resources." <http://www.earthsharing.org.au/facts-and-figures/>
- ¹⁰ Mason Gaffney, "The Hidden Taxable Capacity of Land: Enough and to Spare," *International Journal of Social Economics*, Vol. 35, Issue 6 (Summer, 2008), on line as a working paper draft at <http://www.economics.ucr.edu/papers/papers07/index.html>
- ¹¹ John Locke, *Two Treatises of Government*, 1690. Section 27.
- ¹² Andro Linklater, *Measuring America: How and Untamed Wilderness Shaped the United States and Fulfilled the Promise of Democracy*. New York: Walker & Co., 2002. p. 44.
- ¹³ *Johnson v M'Intosh*, 21 U.S. 8 Wheaton 1, 1823.
- ¹⁴ John C. Weaver, *The Great Land Rush and the Making of the Modern World, 1650 – 1900*. Montreal: McGill-Queens University Press, 2003; Lindsay G. Robertson, *Conquest by Law: How the Discovery of America Dispossessed Indigenous People of their Lands*. London: Oxford University Press, 2005; and Robert J. Miller, *Native America, Discovered and Conquered: Thomas Jefferson, Lewis & Clark, and Manifest Destiny*. Westport, CT: Praeger, 2006.
- ¹⁵ Paul Wallace Gates, *Landlords and Tenants on the Prairie Frontier*. Ithaca: Cornell University Press, 1973.
- ¹⁶ Peter Charles Hoffer, *Law and People in Colonial America*. Baltimore: Johns Hopkins University Press, 1992.
- ¹⁷ Aaron Sakolski, *Land Tenure and Land Taxation in America*. New York: Robert Schalkenbach Foundation, 1957.
- ¹⁸ *Green v Biddle*, 8 U.S. Wheaton 1, 1823.
- ¹⁹ Richard White, *It's Your Misfortune and None of My Own: A New History of the American West*, Norman, OK: University of Oklahoma Press, 1991.